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FEDERAL INCOME TAX TREATMENT OF COMMODITY TRANSACTIONS†

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The Federal income tax treatment of commodity transactions has received a great deal of attention in recent years, culminating in the enactment in 1981 of an entirely new comprehensive tax regimen contained in Title V (Title V) of the Economic Recovery Tax Act of 1981 (ERTA).¹ Prior to the enactment of Title V, a number of unresolved legal issues relating to the Federal income tax treatment of commodity transactions and a number of anomalous tax results attributable to the application or nonapplication of existing rules resulted in taxpayers achieving (or attempting to achieve) extremely favorable tax consequences. Specifically, commodity transactions could be structured to provide taxpayers with both the ability to defer tax by generating tax losses without corresponding economic losses and the ability to "convert" ordinary income or short-term capital gain into long-term capital gain.²

The provisions of Title V³ were developed largely in response to a general perception that the commodity markets were being used to generate unintended and inappropriate tax benefits.⁴ As a result of an audit program initiated by the Internal Revenue Service (the Service) to thwart the use of relatively simple commodity futures straddle transactions to defer income, the

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¹ Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

² JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT, 282 (1981) [hereinafter cited as GENERAL EXPLANATION].

³ Title V added §§ 1092, 1234A and 1256 to the Internal Revenue Code of 1954, as amended ("the Code"), and amended §§ 263, 1212, 1221, 1232, and 1236. Unless otherwise specified, all "\$" references are to the Code and all references to the Regulations ("Reg") are to the Treasury Income Tax Regulations and Procedure and Administration Regulations promulgated thereunder.

⁴ See GENERAL EXPLANATION, *supra* note 2, at 282.

Service comprehended the magnitude of the revenue affected and the myriad of transactions used both to defer income and convert short-term gain and ordinary income into long-term capital gain. This awareness led to a comprehensive legislative effort that ultimately resulted in the enactment by Congress of Title V.

In order to understand the new Code provisions and the reasons for their enactment, a fundamental understanding of the tax law applicable to commodity transactions prior to Title V (and how various transactions were structured to maximize potential tax benefits) is necessary. This article first will examine the basic mechanics of a futures and forward transaction, highlighting certain of the tax issues and problems that existed. Second, transactions utilized by taxpayers in order to generate tax benefits will be described briefly.⁵ Third, new concepts and rules contained in Title V and their application to the various commodity products that were being traded at the time of enactment will be explained and illustrated. Finally, a brief examination of certain issues that remain unresolved will be presented, including those relating to new commodity products that were not available for trading at the time Title V was enacted.

I. FUNDAMENTAL TAX ISSUES RAISED BY THE MECHANICS OF COMMODITY FUTURES AND FORWARD TRANSACTIONS

Commodity transactions may be negotiated privately, or they may be conducted utilizing domestic or foreign commodity exchanges. In either event, the mechanics of such transactions give rise to unique tax issues that were unresolved prior to the enactment of Title V. Thus, a basic familiarity with the mechanics of commodity transactions is necessary in order to understand the potential tax benefits that were available prior to Title V and the effect of Title V on those benefits.

A. *Execution and Holding of a Commodity Futures Contract and a Commodity Forward Contract*

Commodity futures and forward contracts are executory contracts that encompass both rights and obligations with respect to other property.⁶ Both types of contracts involve an agreement for the purchase and sale in the future of a

⁵ While the publicity surrounding the legislative effort involving Title V was directed at the use of commodity transactions to generate tax benefits by other than commodity professionals, except as noted herein, the new rules apply to all commodity transactions without regard to the status of the taxpayer. As will be discussed, the most significant aspect in this regard is the "hedging" exception to the various rules provided throughout Title V. The "hedging" exception represents an acknowledgment of the concerns of certain participants using the commodity markets strictly for business (as opposed to tax) purposes, e.g., farmers and commodity dealers. See *infra* text accompanying notes 120-31.

⁶ See *Commissioner v. Covington*, 120 F.2d 768, 770 (5th Cir. 1941), *cert. denied*, 315 U.S. 822 (1942).

specified quantity of a specified commodity at a specified price. The person initiating a futures or forward contract acquires either the right and obligation to purchase the underlying property in the future (a long position) or the right and obligation to sell the underlying property in the future (a short position). The other party to the contract acquires a corresponding "short" or "long" position.

Futures contracts generally are distinguished from forward contracts in that their terms are standardized and they are traded on an exchange. With respect to futures contracts traded on domestic exchanges, the exchange clearinghouse ultimately is substituted as the corresponding party to all futures contracts. Thus, the clearinghouse functions as the seller to every buyer and the buyer to every seller.⁷ In contrast, forward contracts are "principal's contracts," i.e., they are negotiated between and continue as contracts directly between the two parties. The terms of the contract may or may not be identical to the terms of a futures contract.⁸

Exchange-traded futures contracts are entered into "flat," i.e., there is no built-in profit or loss in the contract, and no consideration is paid by either party to the other at the time of execution of the contract.⁹ Due, however, to the extreme volatility of the commodity markets (which volatility could produce an unabsorbable loss for one or the other party to the contract), a security mechanism has developed to protect both parties (and the clearinghouse) from market movements which could cause either party to be unable to fulfill its obligations. This mechanism requires each party to a futures contract to deposit a security payment (initial margin) with his broker at the time of execution of the futures contract.¹⁰ Further, at the end of each trading day, each party's position is "marked to market," and a redetermination of the amount of margin which must be posted is made (variation margin).¹¹ As the futures price

⁷ When a customer acquires a futures position (either long or short), there is always another customer entering into the other side of his contract through the mechanism of the clearinghouse, though such corresponding customers ordinarily would never meet. The other customer may be acquiring a new futures position or entering into the transaction to close out an existing position.

⁸ For a more complete discussion of the mechanics of futures and forwards contracts, see Schapiro, *Commodities, Forwards, Puts and Calls — Things Equal to the Same Things Are Sometimes Not Equal to Each Other*, 34 TAX LAW. 581, 582-84 (1981). See also REPORT OF THE ADVISORY COMMITTEE ON MARKET INSTRUMENTS TO THE CFTC ON RECOMMENDED POLICIES ON FUTURES, FORWARD AND LEVERAGE CONTRACTS AND TRANSACTIONS, reprinted in [1975-1977 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶ 20,192 (July 16, 1976).

⁹ The only cost associated with the acquisition of the rights and obligations in a futures contract is the transaction cost paid to the broker.

¹⁰ This initial margin deposit in commodity futures transactions should not be confused with the margin required in securities transactions. In a securities transaction, margin serves as collateral security for an existing indebtedness, with the indebtedness representing the cost (or tax basis) of property acquired. In contrast, there is no cost (or tax basis) involved in acquiring the contractual rights and incurring the obligations in a futures transaction. Margin for a futures contract is simply a mechanism intended to assure the ability of a party to perform executory obligations.

¹¹ Marking to market requires daily cash adjustments of margin to reflect daily

of the underlying commodity fluctuates, the apparent result is that one party has a valuable contract and the other party has a losing contract. The payment or receipt of cash variation margin on a daily basis, however, in effect eliminates any profit or loss built into the contract rights, since all deliveries pursuant to the contract are made at the then-current market price.

As described above, a party holding a futures contract actually may receive variation margin substantially in excess of his initial margin deposit or may be required to make payments substantially in excess of his initial margin deposit.¹² Under the tax law prior to Title V, the generally accepted view was that no gain or loss was realized or recognized by virtue of the receipt or payment of variation margin until the contract was sold or otherwise disposed of.¹³ This view represents a proper result. Analytically, any income or loss attributable to a futures contract results only from the appreciation or decline in the value of the contract, and the recognition of such gain or loss with respect to property generally occurs only upon the sale or other disposition of the property.¹⁴ In the case of a futures contract, absent statutory creation of a deemed sale or disposition,¹⁵ no income or loss exists until the transaction is closed.

But for the daily receipt of variation margin, there would be no doubt that mere accretion in value of a contract right does not constitute realized income.¹⁶ Careful analysis of the receipt of variation margin under traditional tax doctrine indicates that treatment of the receipt of variation margin as income would be inappropriate. While there may be potential arguments based upon the "claim of right"¹⁷ or "constructive receipt"¹⁸ doctrines, two specific

movements in the market. At the close of each trading day, all futures contracts are marked to the current settlement prices for like contracts acquired on that day. To the extent that a purchaser's potential obligation has become less onerous (i.e., with respect to a long position, the commodity's value has increased or, with respect to a short position, the commodity's value has decreased), there is less need for his margin, and a portion is remitted to the purchaser. In contrast, a party to a futures contract whose potential obligations have increased due to market movement would be required to remit additional margin to his broker.

¹² The exchange clearinghouse serves as the vehicle through which amounts from the "losers" are remitted to the "winners."

¹³ In the only authority discussing this issue specifically, *H. Elkan & Co.*, 2 T.C. 597 (1943), the court refused to decide whether the receipt of variation margin constituted realized income because the Service did not present sufficient proof with respect to the amount of the taxpayer's net margin withdrawals.

¹⁴ I.R.C. § 1001(c) provides that recognition of gain or loss generally occurs only upon the sale or exchange of property. Moreover, Reg § 1.165-1(b) provides: "To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions."

¹⁵ See, e.g., I.R.C. §§ 1256(a)(1) and 1256(c).

¹⁶ See *Eisner v. Macomber*, 252 U.S. 189 (1920); *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (1921). See also *H. Elkan & Co.*, 2 T.C. 597, 602 (1943) ("Generally speaking, appreciation in the value of property or to state it differently, unrealized profit thereon, is not taxable. The gain or profit must be realized.").

¹⁷ Income is taxable under the claim of right doctrine in the year the taxpayer receives the funds in question, treats them as his own, and concedes no offsetting obligation. See *North Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932); *United States v. Lewis*, 340 U.S. 590 (1951).

¹⁸ The constructive receipt doctrine prescribes that a taxpayer may not postpone the in-

characteristics of a futures transaction prevent application of either doctrine. First, until the transaction is completed, there is no proper way to measure the portion of the amount received, if any, that ultimately will constitute income. A taxpayer with gain at the end of one trading day could have his entire gain eliminated, and indeed incur a loss, by the time the transaction is closed.¹⁹ Further, at least in the case of the holder of a long futures contract, since the holder will pay the then-current market price for the commodity if delivery is taken, any variation margin previously received must be reinvested in the commodity acquired at delivery, thereby reducing his cost of the purchase transaction (with a reduced basis equal to the contract price). The necessity to "repay" the receipt of variation margin in order to take delivery makes it look as though the recipient merely is holding purchase payments for the benefit of the seller (who otherwise would use the amounts to acquire the commodity at the market price and sell at the contract price).

*B. Terminating Contract Rights and Obligations
Prior to the Delivery Date*

The income tax treatment of transactions in which one party terminated its rights and obligations in the contract prior to delivery resulted in anomalous tax consequences under prior law. The application of relatively settled rules resulted in a taxpayer holding a forward contract having the ability to generate capital gains with respect to profitable positions and ordinary losses with respect to losing positions.²⁰

With respect to most executory contracts, a party desiring to terminate his rights and obligations could accomplish this result in one of two ways. First, a winning party, if the contract so provides, can assign the contract to a third party. The other original party to the contract would continue to hold his rights and obligations, but they would run from and to a new party. Similarly, if the losing party desires to terminate any future obligations, and the contract so provides, he can pay a negotiated amount to a third party to assume the obligations. Alternatively, either party could contact the other and attempt to negotiate an extinguishment of their contractual rights and obligations. From the economic standpoint of the party attempting to "liquidate" his gain or loss,

clusion in taxable income of funds that have been earned and are within the taxpayer's control. See *Hyland v. Commissioner*, 175 F.2d 442 (2d Cir. 1949); Reg. § 1.446-1(c)(1).

¹⁹ In circumstances in which the value of property cannot be ascertained, it is impossible to compute taxable gain or loss. Therefore, the transaction is considered "open," and no gain or loss is recognized until the property can be valued. See *Burnet v. Logan*, 283 U.S. 404 (1931); *Baumer v. United States*, 580 F.2d 863 (5th Cir. 1978); *Estate of Meade v. Commissioner*, 489 F.2d 161 (5th Cir.), cert. denied, 419 U.S. 882 (1974); *Dennis v. Commissioner*, 473 F.2d 274 (5th Cir. 1973).

²⁰ See Costello, *Tax Consequences of Speculation and Hedging in Foreign Currency Futures*, 28 TAX LAW. 221, 229-236 (1975); Schapiro, *Tax Aspects of Commodity Futures Transactions, Forward Contracts and Puts and Calls*, 39 NYU ANN. INST. ON FED. TAX, § 16, 16-32 to 16-33 (1981).

the decision whether to transfer or extinguish the contract should be neutral. Under prior tax law, however, there was a significant distinction between the treatment accorded the party who transfers his contract rights and the party who negotiates an extinguishment of the contract.²¹

The definition of capital gains and losses requires that there be a "sale or exchange" of a capital asset.²² Under prior law, courts generally held that the extinguishment of an executory contract produced ordinary rather than capital gain or loss. The theory for such treatment was that, since the property ceases to exist, no property is transferred when a contract is extinguished.²³ Thus, the form of the transaction chosen by a party terminating his contractual rights and obligations would determine the tax consequences. A winning holder would be motivated to assign the contract, achieving capital gain treatment, and a losing holder would be motivated to extinguish the contract. It therefore took very lit-

²¹ For a more extensive discussion of this distinction, see generally Schapiro, *Commodities, Forwards, Puts and Calls — Things Equal to the Same Things Are Sometimes Not Equal to Each Other*, 34 TAX LAW. 581 (1981).

²² I.R.C. § 1222.

²³ In *Commissioner v. Starr Bros*, 204 F.2d 673 (2d Cir. 1953), the Court of Appeals for the Second Circuit held that the consideration paid for cancelling an existing contract between the taxpayer and a drug manufacturer, United, did not constitute capital gain because there was no sale or exchange of a capital asset. The court stated:

What the taxpayer gave in return for the cash payment was a release of United's contract obligations Such release not only ended the promisor's previously existing duty, but also destroyed the promisee's rights. They were not transferred to the promisor, they merely came to an end and vanished. . . . When Congress has wished to tax as capital gains receipts which would not fall within the ordinary meaning of "sale or exchange" of assets, it has dealt specifically with such transactions. . . . We regard as significant the absence of any statutory provision treating the termination or modification of a selling agency contract as a sale or exchange.

Id. at 674-75.

Among the cases adopting this reasoning are *Commissioner v. Pittston Co.*, 252 F.2d 344, 348 (2d Cir.), *cert. denied*, 357 U.S. 919 (1958) (cancellation of naked contract right to purchase coal output did not involve sale); *Leh v. Commissioner*, 260 F.2d 489, 494 (9th Cir. 1958) (termination of contract to purchase gasoline output was not a sale or exchange). Since 1956, the Service has accepted the *Starr Bros* rationale. See Rev. Rul. 56-531, 1956-2 C.B. 983 ("The Service will continue to regard the relinquishment of simple contract rights as not involving the sale or exchange of a capital asset within the meaning of Section 117 of the Code and will treat amounts received in consideration of such relinquishment as constituting ordinary income under Section 22(a) of the Code.") See also Rev. Rul. 58-394, 58-2 C.B. 374 (relinquishment of simple contract rights held not a sale or exchange). In the past, the tax treatment of analogous types of contractual rights and obligations in situations involving patents, franchises, leaseholds, and stock options caused similar confusion. Issues, such as the status of intangible rights and obligations as property apart from the underlying property, and whether the extinguishment of contractual rights and obligations constituted a "sale or exchange," raised in these other contexts often generated contradictory authority. Compare *Commissioner v. Golonsky*, 200 F.2d 72 (3d Cir. 1952) (lease itself is property apart from underlying property leased; complete transfer of cancellation of leasehold interest is "sale or exchange"), *cert. denied*, 345 U.S. 939 (1953) with *United Cigar-Whelan Stores Corp. v. District of Columbia*, 176 F.2d 952 (D.C. Cir. 1949) (cancellation of leasehold interest is termination of interest, not a transfer, not a "sale or exchange"). The ultimate resolution of the confusion in these analogous areas was a comprehensive legislative regimen intended to codify the appropriate results. See I.R.C. §§ 1235 (patents), 1253 (franchises), 1241 (leases) and 1234 (options).

the imagination to structure transactions that would accommodate the tax needs of all parties.²⁴

In contrast to parties to forward contracts, a party to a futures contract may not choose the form by which he terminates his contractual rights and obligations. In order to terminate his rights and obligations prior to delivery he must enter into a "closing" or a "set-off" transaction. A closing transaction involves the acquisition of either a long position (if the trader wishes to liquidate a short position) or a short position (if the trader wishes to liquidate a long position) covering the same specified commodity with the same delivery month.²⁵ Such transaction has the effect of liquidating a trader's preexisting long or short position rather than resulting in the trader acquiring new rights and obligations in the offsetting position.

The tax issue raised under prior law by a futures closing transaction concerned whether the transaction constituted a sale or exchange of the original contract, a deemed purchase and sale of the commodity, an extinguishment of the contract, or the acquisition and disposition of the position used as an offset. The available authority with respect to the disposition of a long futures contract indicates that such a transaction would be treated as a sale or exchange of the contract.²⁶ Logic would dictate that the same characterization would apply to the disposition of a short futures contract. Dicta in a recent Tax Court decision,²⁷ statements in the legislative history of ERTA and a number of commen-

²⁴ See, e.g., *Hoover Co.*, 72 T.C. 206, 249 (1979) (taxpayer had the opportunity to structure its transactions involving the termination of its rights and obligations under forward contracts so as to constitute a "release" or an "offset"); *American Home Prod. Corp. v. United States*, 601 F.2d 540, 548 (Ct. Cl. 1979) (in structuring transactions involving forward contracts, the court noted: "That [the taxpayer] may have had tax consequences in mind when it made the assignment is clearly beside the point A taxpayer has the option to select a transaction which will legally minimize taxes.") See also *Carborundum Co.*, 74 T.C. 730 (1980); *International Flavors & Fragrances, Inc.*, 36 T.C.M. (CCH) 260 (1977), *appeal dismissed* (2d Cir. 1978).

²⁵ For example, assume a trader entered into a futures contract to purchase June wheat at \$10 per bushel and two months later June wheat went to \$15 per bushel. Under the rules of all domestic futures exchanges, the trader is not allowed to sell his rights to acquire the June wheat at \$10 per bushel, nor is he allowed to negotiate with the clearinghouse to obtain a release from his rights and obligations. Instead, the trader is permitted to enter into a closing transaction whereby he executes a sell contract for June wheat at \$15 per bushel. As a result of the trader's assumption of a short position, his long and short positions would be netted against one another, and he would receive (or retain from amounts already received) \$5 per bushel and have no remaining rights or obligations with respect to either contract. Indeed, unless he were a "hedger," it would be illegal for him to hold both contracts simultaneously.

²⁶ See *Commissioner v. Covington*, 120 F.2d 768, 770 (5th Cir. 1941), *cert. denied*, 315 U.S. 822 (1942) (court held that settlement of a commodity futures contract by offset constituted a sale or exchange of rights in commodities); *Ernest Vickers, Jr.*, 80 T.C. No. 14 (1983) (the court stated that a futures closing transaction is a sale by a trader of his long or short position in the futures contract to a second trader with the clearinghouse as intermediary); *Rev. Rul. 78-414*, 78-2 C.B. 213 (gain realized with respect to the offset of a Treasury bill futures contract held as a capital asset constitutes capital gain presumably because the offset involves the sale of the contract rights, not the underlying commodity).

²⁷ See *Harry Lee Smith*, 78 T.C. 350, 385-90 (1982).

tators,²⁸ however, have suggested without explanation that the short sale rules contained in section 1233²⁹ require that capital gain realized with respect to a short futures contract closed by offset will be short-term capital gain regardless of the taxpayer's holding period in the contract rights. The only characterization of a short futures contract that could result in the application of the short sale rules requires that the original short futures contract be viewed merely as a short sale of a long futures contract, which contract is delivered at the time of set-off. This strained characterization goes well beyond the stated scope of inclusion of futures contracts in other areas of the short sale provisions.³⁰

C. *Taking or Making Delivery of the Underlying Commodity*

While delivery pursuant to a futures contract occurs in few cases, the trader holding a long or short futures contract position has the right to take or make delivery. The most significant tax issue relating to delivery transactions arose from the fact that there is no provision which states that the character of gain or loss on a futures or forward contract (as capital gain or loss or ordinary gain or loss) is determined by reference to the character of the underlying property.³¹ Thus, unrealized gain or loss with respect to a futures or forward posi-

²⁸ See S. REP. NO. 144, 97th Cong., 1st Sess. 144 nn.15 & 16, 149, 156 (1981); GENERAL EXPLANATION, *supra* note 2, at 280-81 & n.5. See also, e.g., Schapiro, *Commodities, Forwards, Puts and Calls — Things Equal To The Same Things Are Sometimes Not Equal To Each Other*, 34 TAX LAW. 581, 586-97 & n.49 (1981); Evans & Schnee, *The "Taxing Rules" on Forward Contracts*, 59 TAXES 443, 445 (1981). But see McCawley, 184-3rd TAX MGMT (BNA), *Trading in Stock Options, Futures and Other Securities: Short Sales and Wash Sales*, A-26-A-28 (1982).

²⁹ I.R.C. § 1233 provides in pertinent part:

(a) *Capital Assets.* For purposes of this subtitle, gain or loss from the short sale of property shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property, including a commodity future, used to close the short sale constitutes a capital asset in the hands of the taxpayer.

(b) *Short-term Gains and Holding Periods.* If gain or loss from the sale is considered as gain or loss from the sale or exchange of a capital asset under subsection (a) and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 1 year . . . , or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof —

(1) any gain on the closing of such short sale shall be considered as a gain on the sale or exchange of a capital asset held for not more than 1 year (notwithstanding the period of time any property used to close such short sale has been held); and

(2) the holding period of such substantially identical property shall be considered to begin . . . on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever date occurs first. . . .

* * *

(e) . . . (2) *For purposes of subsections (b) . . . (A)* The term "property" includes only stocks and securities (including stocks and securities dealt with on a "when issued" basis), and commodity futures, which are capital assets in the hands of the taxpayer. . . . [Emphasis added.]

³⁰ See Ernest Vickers, Jr., 80 T.C. No. 14, n.14 (1983) ("As we and other courts have stated before, section 1233 is a very specific, detailed and intricately woven tax statute which should not be extended by analogy beyond its narrow sphere.")

³¹ This should be contrasted with the statutory rule applicable to options. I.R.C. §

tion could be "converted" prior to realization by taking or making delivery and shifting built-in gain or loss to the underlying property (which could have a different "character").

Under the law prior to Title V, gains and losses on futures contracts normally would be considered capital gains or losses.³² Thus, a taxpayer with an unrealized capital loss with respect to a futures contract, if the underlying property would not be a capital asset in his hands, could take or make delivery of the underlying property and generate ordinary loss.³³ If there were unrealized gain with respect to the contract, he was able to generate long-term capital gain by selling the contract after holding it for the requisite period of time.³⁴

II. IMPETUS FOR THE CHANGE IN THE TAX LAW

The lack of a consistent, comprehensive regimen dealing with the tax treatment of commodity transactions (and the corresponding anomalous consequences) resulted in the aggressive marketing of numerous tax shelter schemes involving commodities to taxpayers that were not commodity professionals, without significant regard for the underlying economics of the transactions. The tax results of four specific types of transactions, "commodity straddles," "T-bill (Treasury bill) straddles," "cash and carry" transactions, and "cancellation" transactions, were identified by the Department of the Treasury (Treasury) as particularly "abusive," and Title V was enacted

1234(a)(1) provides:

Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

³² The courts have held that futures contracts will not be considered inventory assets and therefore excluded from the definition of a capital asset under I.R.C. § 1221(1). *See* Farroll v. Jarecki, 231 F.2d 281, 287 (7th Cir. 1956) (commodity futures may not be held primarily for sale to customers in the ordinary course of the taxpayer's trade or business); *Commissioner v. Covington*, 120 F.2d 768, 770 (5th Cir.), *cert. denied*, 315 U.S. 822 (1941) (commodity futures that are not hedges held to be capital assets in the hands of a trader); *Ernest Vickers, Jr.*, 80 T.C. No. 14 (1983) (speculative commodity futures transactions are capital transactions). Taxpayers acquiring commodity futures contracts as integral parts of their trade or business, however, would be considered hedgers and gain or loss with respect to such contracts would be considered ordinary income or loss. *See* *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).

³³ For example, prior to the enactment of Title V, Treasury bills were excluded specifically from the definition of capital assets in § 1221. Therefore, taxpayers could convert an unrealized capital loss in a Treasury bill futures contract into an ordinary loss by either taking or making delivery of the underlying Treasury bills. *See infra* discussion of T-bill Straddles at text accompanying notes 53-57.

³⁴ § 1222 provided that the holding period for long-term capital gain or loss with respect to a futures contract is six months. This reduced holding period continues under present law to apply to futures contracts that are not subject to the new mark to market rules. *See infra* discussion of § 1256 at text accompanying notes 132-70.

Another open issue relating to delivery included whether the special holding period (six months) for obtaining long-term capital gain treatment with respect to futures contracts would apply to property acquired pursuant to delivery on a futures contract.

specifically to stem the use of such transactions to defer income and to convert ordinary income and short-term capital gain into long-term capital gain. The marketing of commodity tax shelters employing such transactions predominantly for tax purposes to nonprofessionals prompted Treasury to generically categorize all such transactions as "abusive." However, notwithstanding Treasury's perception and the motivation of the nonprofessionals seeking tax shelters, as is the case with respect to most tax shelters, all of the types of transactions to be discussed can be (and have been) conducted in a manner providing significant opportunity for profit and generating significant risk of loss.

A. *Commodity Straddles*

Investors with substantial short-term capital gain would enter into commodity "straddle" transactions in an attempt to defer the gain to a subsequent year and to convert the gain into long-term capital gain. Such tax planning strategies were heavily marketed and received much publicity during the late 1960's and 1970's.³⁵ The basic straddle transaction initially generated the controversy that ultimately resulted in the enactment of Title V as part of ERTA.

Straddle transactions consisted of many variations on a theme.³⁶ In its simplest form, a straddle involved the acquisition of two or more market positions expected to generate equal market movement in opposite directions.³⁷ For instance, consider a simple straddle consisting of two futures contracts in silver. An investor might acquire a long position which would require him to purchase and take delivery of a specified quality and quantity of silver in a specified month. The investor also would acquire a short position obligating him to sell the same quality and quantity of silver in a different month.³⁸

³⁵ See, e.g., Goldfein, *Commodity Straddles*, in J. SCHREIBER & J. SULLIVAN, *HOW TO USE TAX SHELTERS TODAY*, 561 (J. Schreiber & J. Sullivan, eds, 1977); Martin, *How T-bill Spreads Can Be Used for Hedging and Tax Deferral Opportunities*, 48 J. TAX. 102 (1978); Goldfein & Hochberg, *Use of Commodity Straddles Can Effect Impressive Tax Savings*, 29 J. TAX. 342 (1968); Levy, *An Analysis of the Commodity Straddle as a Tax Planning Device*, 59 TAXES 467 (1981); Baldwin, *Avoiding Taxes Through T-Bills*, 127 *Forbes* 161 (March 30, 1981); Knight & Rowe, *Silver Butterfly: The Best Little Tax Dodge in America*, WASHINGTON POST (Dec. 21, 1981).

³⁶ All the transactions identified as "abusive" were forms of the basic straddle transaction.

³⁷ Such straddle positions might consist of futures contracts, forward contracts, or the ownership of the physical commodity. It should be noted that a great deal of money can be made, or lost, engaging in transactions expected to generate offsetting gain or loss, and that most professional commodity dealers or traders enter into some form of offsetting positions attempting to generate profit from pricing spreads while minimizing their risk. The focus of the initial attack on straddle transactions was on transactions perceived to be undertaken solely (or at least principally) for tax purposes, but, subject to one major exception — hedging transactions. See GENERAL EXPLANATION, *supra* note 2, at 282; see also notes 120-31 and accompanying text. The resulting legislation applies to all such transactions.

³⁸ The short sale rules of § 1223 would not apply to these positions because futures contracts requiring delivery in different months are not considered to be "substantially identical." See REG. § 1.1223-1(d)(2)(i).

Any market move would create a potential "winning leg" and a potential "losing leg" in the straddle, thereby providing the taxpayer with unrealized gain in the winning leg and an unrealized loss in the other leg. The investor could close out the losing position, attempting to generate currently recognizable loss, and continue to hold the winning position until a subsequent tax year.³⁹ The current loss would be used to offset any capital gain realized and recognized during the year. Then to maintain a balanced market position, the investor generally would replace the leg that generated the loss with another futures contract expected to move equally in an opposite direction from the retained leg.⁴⁰ The investor then would close out the winning leg (and the replaced leg) in the subsequent year, hopefully recognizing the gain on that leg at long-term capital gain rates.⁴¹

A simple straddle thus could enable a taxpayer to recognize currently a short-term capital loss to offset other capital gains, thereby deferring tax on the gain, while hopefully converting the gain from short-term capital gain into long-term capital gain, all with a minimum of economic risk.⁴² Moreover, since the initial margin requirements for straddle positions are very low (especially relative to the potential tax savings), and since at all times the unrealized gain in the winning position approximately would equal the unrealized loss in the losing leg (thereby eliminating any net loss from the aggregate of the offsetting positions), the taxpayer ordinarily would not be required to deposit any additional variation margin.

Taxpayer use of commodity straddles for deferral and conversion received much attention from Congress and the Service due in large part to straddle transactions entered into by two investors in 1973. The two investors had

³⁹ I.R.C. § 1222 provides that the gain or loss attributable to the sale or exchange of a futures contract held as a capital asset for more than six months will be considered long-term capital gain or loss.

⁴⁰ Under established precedent, the wash sale rules of § 1091 did not apply to defer the recognition of loss when the position was reestablished because futures contracts were not considered "stocks or securities" for purposes of § 1091. See *Corn Products Refining Co. v. Commissioner*, 215 F.2d 513, 516-17 (2d Cir. 1954), *aff'd on other grounds*, 350 U.S. 46 (1955); *Sicanoff Vegetable Oil Corp.*, 27 T.C. 1056, 1066 (1957), *rev'd on another issue*, 251 F.2d 764 (7th Cir. 1958); *Harry L. Smith*, 78 T.C. 350, 385-90 (1982); Rev. Rul. 71-568, 1971-2 C.B. 312. *Contra*, *Trenton Cotton Oil Co. v. Commissioner*, 147 F.2d 33, 36-37 (6th Cir. 1945).

⁴¹ It was generally believed that only the holder of a long position would receive long-term capital gain treatment. The theory, though not free from doubt, was that the "short sale" rules prevented long-term capital gain on the short side. See *supra*, discussion at text accompanying notes 20-30. If the investor was unsuccessful in generating long-term capital gain, or if the investor was unwilling to incur tax even at those rates, there was nothing (at least until Title V) that prevented perpetual deferral of the gain by entering into a new straddle transaction in the subsequent year.

⁴² In many instances, more sophisticated straddles, such as "butterfly straddles," were employed to further minimize the risk of entering into the transactions. A butterfly straddle utilizes three different delivery months instead of the two months used in a simple straddle. For example, in month one, a taxpayer might be long five contracts, short ten contracts in month two, and long five contracts in month three. The taxpayer has straddled ten long and ten short contracts, but has "butterflied" (doubly protected) the middle position.

realized substantial short-term capital gains from real estate transactions and were advised by their broker to enter into a "butterfly" straddle in order to defer recognition of the gain with the hope that an equivalent long-term capital gain would be generated in a subsequent taxable year.⁴³ The straddles were executed and ostensibly generated current short-term capital loss sufficient to offset their real estate short-term capital gain with a resulting deferral of the gain and recognition and realization as long-term capital gain in the following year.

On audit, the Service disallowed the losses resulting from the transaction on the basis that the straddle transaction was not entered into with a genuine expectation of profit. The agent reasoned that the losing leg of the straddle was offset effectively by the winning leg and, therefore, the transaction was a "sham" which the investors entered into solely to avoid tax.⁴⁴ Thereafter, the Service published Rev. Rul. 77-185⁴⁵ to support its position that the straddle transactions produced no recognizable loss.

⁴³ On August 7, 1973, Harry Lee Smith and Herbert J. Jacobson each acquired 21 long positions in March 1974 silver futures contracts, 21 long positions in December 1974 silver futures contracts, and 42 short positions in July 1974 silver futures contracts. On August 9, 1973, Smith and Jacobson each acquired 21 long positions in May 1974 silver futures contracts, 21 long positions in September 1974 silver futures contracts, and 21 short positions in March 1974 silver futures contracts, and 21 short positions in December 1974 silver futures contracts. Harry L. Smith case, 78 T.C. 350, 358 (1982).

⁴⁴ At the agent's request, the Service's National Office considered the technique involved in the transaction and originally issued a technical advice memorandum stating that the transaction was valid for tax purposes. The agent, however, persisted in his views and resubmitted a request for advice to the National Office. This time, the Service agreed with the agent and decided that the net loss arising from the transaction would not be recognized. Barber, *New Tax Developments*, 35 BUS. LAW. 871, 882 (1980).

⁴⁵ Rev. Rul. 77-185, 1977-1 C.B. 49, sets forth the Service's position regarding commodity straddles. This ruling, however, does not refer to a butterfly straddle transaction. The ruling utilizes and disallows losses resulting from a simple straddle rather than a butterfly straddle. In the ruling, the hypothetical taxpayer entered into the following three transactions to minimize the tax consequences of a noncommodity related short-term capital gain of 150x dollars incurred in 1975.

- (1) On August 1, 1975, the taxpayer:
 - (a) sold short 40 July 1976 silver futures contracts for 2,000x dollars; and
 - (b) purchased 40 long March 1976 silver futures contracts for 1,951x dollars.
- (2) On August 4, 1975, the taxpayer:
 - (a) sold the 40 March 1976 silver futures contracts for 1,825x dollars, thus closing out the long position in March silver acquired three days before and generating a loss to the taxpayer; and
 - (b) purchased 40 long May 1976 silver futures contracts for 1,851x dollars.
- (3) On February 18, 1976, the taxpayer:
 - (a) sold the 40 May 1976 silver futures contracts for 2,025x dollars, thus generating a gain; and
 - (b) closed out the short position in 40 July 1976 futures by purchasing 40 long July 1976 silver futures for 2,051x dollars, thus generating a loss.

Id.

Due to the minimum risk from these spread transactions, the margin required by the mark to market rules of the clearinghouse was only one-fourth of one percent of the dollar value of the total futures contracts purchased or approximately 10x dollars. The commission on closing each transaction was 2x dollars. *Id.*

In 1975, the taxpayer reported a short-term capital gain of 150x dollars and a short-term

According to the ruling, under relevant principles of tax law,⁴⁶ a taxpayer must suffer a "real" economic loss in the year the loss is claimed before a deduction will be allowed. Applying this standard to the hypothetical taxpayer in the ruling, the Service determined that no "real change of position in a true economic sense" had occurred when the loss legs of the straddles were closed out because the immediate purchase of new offsetting positions enabled the taxpayer to continue to hold a balanced position in silver contracts. The Service did not view the close out of the loss leg as the termination of a taxable transaction. Rather, the Service ruled that the closing transaction was nothing more than one of the steps necessary to maintain the straddle, and the taxpayer suffered no economic loss since he remained in the same balanced position both before and after the transaction which generated the loss. Thus, the loss was disallowed.⁴⁷ The Service's position as set forth in Rev. Rul. 77-185 generated substantial criticism⁴⁸ and a great deal of tax litigation as more and more "tax straddles" were marketed to the public.

capital loss of 128x dollars resulting from the sale of the 40 March 1976 silver futures (1,951x dollars — 1,825x dollars + 2x dollars commission = 128x dollars). The taxpayer desired to offset this \$128x short-term capital loss against his unrelated \$150x dollars of short-term capital gain for 1975 thus leaving 22x dollars as the taxable net short-term gain for the year. *Id.* In 1976, the taxpayer reported a long-term capital gain of 172x dollars resulting from the sale of the 40 May 1976 silver futures (2,025x dollars — 1,851x dollars — 2x dollars commission) plus a short-term capital loss of 53x dollars resulting from the short sale of the 40 July 1976 silver futures (2,051x dollars — 2,000x dollars + 2x dollars commission) leaving 119x dollars as the net long-term gain. *Id.* See I.R.C. § 1212(11).

⁴⁶ The ruling disallows all losses resulting from straddle transactions relying upon Reg. § 1.165-1(b), Frederick R. Horne, 5 T.C. 250 (1945), and Gordon MacRae, 34 T.C. 20 (1960). Rev. Rul. 77-185, 1977 - C.B. 49, 49. Section 1.165-1(b) of the Regulations states that a loss is allowable as a deduction under section 165(a) of the Code only if it is evidenced by a closed and completed transaction, fixed by identifiable events, and actually sustained during the taxable year. *Id.* Horne adds that the taxpayer must be out of pocket to the extent of the claimed loss after the relevant transaction is completed, and the transaction must have been capable of producing some business advantage for the taxpayer. *Id.* MacRae stands for the proposition that a deduction will not be allowed if it results from a transaction that is merely a series of steps taken solely to create the deduction. *Id.* Each purchase and sale may appear genuine when considered separately, but if together they constitute a complicated method for doing nothing of genuine economic substance, the entire transaction is a "sham." *Id.* at 50.

⁴⁷ Additionally, the ruling disallowed a deduction for out-of-pocket losses resulting from broker's commissions incurred in 1976 when all of the futures transactions were closed out. Rev. Rul. 77-185, C.B. 49, 50. Since the ruling found that the taxpayer's "dominant purpose" for buying and selling silver futures was to create an artificial short-term capital loss without risk, the entire transaction lacked economic substance, and no deductions claimed with respect to the transaction were allowed. *Id.* Shortly after the ruling was published, Rev. Rul. 78-414, 1978-2 C.B. 213, stated that the same principles would be applicable to straddles composed of financial futures contracts.

⁴⁸ Rev. Rul. 77-185, ignored precedent established by the Court of Appeals for the Fifth Circuit in *Valley Waste Mills v. Page*, 115 F.2d 446 (5th Cir. 1940), *cert. denied*, 312 U.S. 68 (1941), and the Court of Appeals for the Second Circuit in *Harriss v. Commissioner*, 143 F.2d 279 (2d Cir. 1944). Both *Valley Waste Mills* and *Harriss* support the assertion that the sale of a futures contract in a straddle constitutes a closed and completed transaction even though a similar contract with a later maturity date is simultaneously purchased.

The articles criticizing the rationale of Rev. Rul. 77-185 include: Dailey, *Commodity*

On March 5, 1982, the Tax Court rendered its decision in the now infamous "silver butterfly case," *Harry L. Smith*, that involved the two investors who sought to shelter their real estate gain.⁴⁹ In *Smith*, the Tax Court applied the law prior to Title V and rejected the legal position of the Service enunciated in Rev. Rul. 77-185. The court held that each component step in the straddle transaction constituted a closed and completed transaction for tax purposes, and that the recognition of such losses would not be postponed until further years.⁵⁰ Nevertheless, the court disallowed the losses claimed by the investors holding that the losses were not incurred in any transaction entered into for profit within the meaning of section 165(c)(2).⁵¹ No appeal was filed in the case.⁵²

B. "T-bill Straddles"

Under prior law, certain government obligations issued on a discount basis payable without interest at a fixed maturity not exceeding one year from the date of issue (basically T-bills) were excluded specifically from the definition of a capital asset.⁵³ Thus, upon the sale of a T-bill all gains and losses were treated as ordinary. T-bill futures contracts, however, generally were considered capital assets if held for investment, and gains and losses with respect to transactions involving T-bill futures were treated as capital gains or losses.⁵⁴ This divergent treatment of the underlying property from the futures contract, coupled with the absence of a legal requirement for parallel treatment of futures contracts and the underlying property, afforded taxpayers the opportunity to create ordinary losses and convert such losses into long-term capital gain with a minimum of risk.⁵⁵

T-bill straddles generally were structured in the same manner as other commodity straddles — a taxpayer would enter into offsetting T-bill futures contracts. In contrast to other straddles, however, at the time of delivery the taxpayer could generate ordinary loss with respect to the losing position either

Straddles in Retrospect: Federal Income Tax Considerations, 47 BRKLYN L. REV. 313 (1981); Levy, *An Analysis of the Commodity Straddle as a Tax Planning Device*, 52 TAXES 467 (1981); Garber, *New Tax Developments*, 35 BUS. LAW. 871 (1980); Selig & Schmittberger, *Tax Aspects of Commodity Futures Trading*, 6 HOFSTRA L. REV. 93 (1979); Barbakoff & Sabin, *Are All Silver Transactions Created Equal? An Analysis of Revenue Ruling 77-185*, 56 TAXES 3 (1978); Goldfein & Hochberg, *An Analysis of IRS' Ruling That Straddle Transactions Lack Requisite Profit Motive*, 47 J. TAX. 142 (1977).

⁴⁹ 78 T.C. 350 (1982).

⁵⁰ *Id.* at 376-90. The court, however, rejected the values assigned by the taxpayers to the straddle positions in after-hours trading sessions and readjusted the amount of the losses sustained by the taxpayers on each straddle to reflect market settlement prices on the days each of the legs were closed out. *Id.* at 378-82.

⁵¹ *Id.* at 390-94.

⁵² This case serves as precedent for tax litigation involving commodity transactions entered into prior to the effective date of Title V of ERTA.

⁵³ Section 1221(5) of the Code prior to ERTA.

⁵⁴ Rev. Rul. 78-414, 1978-2 C.B. 214.

⁵⁵ See Kane, *Tax Treatment of Treasury Bill Futures*, 52 S.C.L. REV. 1555 (1979).

by taking delivery and selling the T-bills, in the case of a long position, or purchasing T-bills and delivering them if the short position were the loser.⁵⁶ As opposed to other straddles, T-bill straddles often would have both contracts with delivery dates prior to year-end in order to insure that the delivery necessary to generate an ordinary loss would occur within the taxable year. Thus, the taxpayer might enter into an additional straddle in order to generate a capital loss to be used to shelter the winning leg of the T-bill straddle and, hopefully, to convert short-term capital gain into long-term capital gain.⁵⁷

C. "Cash and Carry" Transactions

"Cash and carry" transactions similarly involved an effort to generate ordinary losses and convert an amount equal to those deductions into long-term capital gain. A taxpayer would purchase a physical commodity and simultaneously acquire a short futures or forward contract for an equivalent amount of the same commodity more than 12 months in the future. Ordinarily, the commodity acquired (and sold short) would be of the type not subject to seasonal variations in supply. Thus, as an economic matter the price differential between the current or "spot" price of the commodity and the futures price largely would be a function of interest and carrying costs. For instance, the precious metal markets are perceived by many to be markets in which the future delivery price of the underlying commodity can be expected to approximate the sum of present price plus interest and carrying charges for the period until delivery. Thus, the short futures contract hypothetically would have a sales price approximately equal to the total payment for the commodity plus interest and carrying costs.

The purchase of the underlying commodity would be financed with borrowed funds and the interest expense, storage, and insurance costs would constitute ordinary deductions which would offset ordinary investment income (dividends and interest) in the first year of the transaction. Once the taxpayer had held the commodity for the requisite 12-month holding period necessary for long-term capital gain treatment, he could either deliver the commodity pursuant to the futures contract or close out the short position and sell the commodity in the market. In either event, the net gain on the two positions was expected to be approximately equal to the previously deducted interest and carrying charges, and would have been taxed at long-term capital gain rates.⁵⁸

⁵⁶ A compensating gain would exist with respect to the other position.

⁵⁷ In addition to the obvious loss of tax revenues resulting from the use of T-bill straddles, Congress and the Treasury were concerned that the demands for delivery on T-bill futures at the end of some years could exceed the supply of deliverable bills, thereby disrupting the T-bill markets. See Statement of John E. Chapoton, Assistant Secretary for Tax Policy, presented to the House Ways and Means Committee, April 30, 1981. *Ways and Means Committee Hearings and JCT Pamphlet on Commodity Tax Straddles*, (statement of John E. Chapoton), TAX MGMT (BNA), Series III, Primary Sources, 97th Cong., III-29 PS-159 (June 6, 1981).

⁵⁸ As with the other deferral and conversion techniques utilized, the potential tax

D. "Cancellation" Transactions

As noted above, the definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. If a disposition of a capital asset was structured so as not to be considered a "sale or exchange" (e.g., a lapse or cancellation), the disposition would produce ordinary income or loss.⁵⁹ Forward contracts for currency or securities were used by taxpayers to take advantage of this "form over substance" treatment. If such a forward contract, held as a capital asset, increased in value, it was sold or exchanged to produce capital gain. If the contract decreased in value, it was cancelled in order to produce ordinary loss. A straddle transaction involving offsetting forward contracts could thereby be used to generate ordinary loss and a corresponding long-term capital gain simply by closing out the two legs in different manners.

III. THE TAXATION OF COMMODITY-RELATED TRANSACTIONS UNDER TITLE V OF ERTA

The new tax regimen imposed upon commodity transactions was developed largely in response to the attention generated by the above-described transactions and, in large measure, by the perception that the commodity markets were being used to generate unintended and inappropriate tax consequences. Title V of ERTA represents a comprehensive effort to close the "loopholes" under prior law that made such results possible.

A. Legislative History of Title V of ERTA

Congressional action to reform the taxation of commodity transactions began with a bill introduced in Congress on June 10, 1980.⁶⁰ The stated purpose of the legislation was to limit the use of commodity straddles as a means of generating tax losses to shelter other income.⁶¹ The bill proposed adding a new section 1092 to the Code which would postpone the recognition of any loss generated by commodity straddles and other offsetting positions in personal property until thirty days after all positions were closed out or the positions became "unstraddled." In addition, the legislation would have suspended the capital gains holding periods of the legs of a straddle for the duration of the time they remained parts of an offsetting position.⁶² As proposed, the legisla-

benefits only were available in cash and carry transactions because the short sale rules of § 1233 were limited in their application to stocks, securities, and commodity futures.

⁵⁹ See *supra* text accompanying notes 20-30.

⁶⁰ H.R. 7541, 96th Cong., 2d Sess., 126 CONG. REC. H4732-34 (daily ed. June 10, 1980), was introduced in the House by Representatives Charles A. Vanik and Benjamin S. Rosenthal.

⁶¹ *Id.*

⁶² Under the proposed legislation, however, the term "offsetting position" did not include positions in commodities which constituted an integral part of the taxpayer's business, such

tion would have applied to offsetting transactions entered into after June 30, 1980. Further, T-bills no longer would have been excluded from the definition of a capital asset. While the bill was never reported out of the House Ways and Means Committee, it nevertheless alerted the commodity industry that change might be imminent and began the process of educating Congress in the intricacies of commodity transactions taxation.

Pressures continued to build for tax reform in the commodity area and the impetus for change met with a very receptive atmosphere in Congress. A new bill aimed at prohibiting the use of tax-motivated commodity straddles was introduced by Representatives William Brodhead and Benjamin S. Rosenthal.⁶³ The Brodhead-Rosenthal bill, proposed on January 27, 1981, originally appeared to have an excellent chance for passage.⁶⁴ As reported out of the House Ways and Means Committee, the bill, which subsequently was incorporated into the House version of ERTA, would have allowed taxpayers to deduct straddle losses only to the extent of gains generated by straddle positions in any taxable year. Disallowed straddle losses were to be carried forward as straddle losses and in subsequent years such losses could only be used to offset straddle gains.⁶⁵

During the period the House was considering the Brodhead-Rosenthal proposal, Senator Daniel P. Moynihan was preparing a similar bill for the Senate.⁶⁶ The bill as reported by the Senate Finance Committee contained a new "mark to market" rule for domestically-traded futures contracts. The pro-

as positions constituting hedges for inventory. Moreover, stock was not considered personal property. *Id.*

⁶³ H.R. 1293, 97th Cong., 1st Sess., 127 CONG. REC. E166-68 (daily ed. Jan. 27, 1981).

⁶⁴ *Financial Futures/Commodities Report*, SECURITIES WEEK, Feb. 2, 1981, at 6. The bill was co-sponsored by two powerful committee chairmen, Representative Fernand J. St. Germain, Chairman of the Banking Committee, and Representative Peter Rodino, Chairman of the Judiciary Panel. The bill was subsequently given priority treatment by the Chairman of the House Ways and Means Committee, Representative Dan Rostenkowski, in that he bypassed the jurisdiction of the subcommittees by bringing the measure directly to the full Ways and Means Committee for consideration.

⁶⁵ "Hedging transactions" were exempted from this provision. In addition, the bill would have amended § 263 of the Code by adding a subsection dealing with interest and carrying cost incurred with respect to commodity transactions. *See* H.R. 1293, 97th Cong., 1st Sess., 127 CONG. REC. E166, 168 (1981). Under the proposal, carrying costs, such as storage and insurance, and interest incurred on funds used to purchase or carry property constituting part of a straddle would have to be capitalized and added to the commodity's basis. *Id.* Futures traders, however, would have been allowed to continue to deduct such charges currently. *Id.* Hedging transactions also were exempted from the capitalization rule. *Id.* T-bills no longer would be excluded from the definition of a capital asset, and a portion of the discount on T-bills would be treated as ordinary income under the bill. *Id.* Further, the House bill required the identification of securities held as investments by securities dealers on the day of acquisition and provided that taxable dispositions of capital assets would be treated as sales or exchanges. *Id.*

⁶⁶ The bill which Senator Moynihan introduced in the Senate on June 25, 1981, S. 1432, was based upon a series of proposals submitted to him in December of 1980 by the outgoing Assistant Secretary of the Treasury for Tax Policy, Donald C. Lubick. S. 1432, 97th Cong., 1st Sess., 127 CONG. REC. S7117-21 (daily ed. June 25, 1981).

vision was designed to require recognition as income or loss amounts corresponding to the daily cash margin requirements employed by commodity futures exchanges in the United States.⁶⁷ The bill also contained a loss deferral rule providing that straddle losses could be taken only to the extent such losses exceed unrealized gains in other straddle positions.⁶⁸ This version of the bill subsequently was incorporated in the Senate version of ERTA.

On August 1, 1981, members of the Senate Finance Committee and the House Ways and Means Committee met in conference to finalize the 1981 tax legislation. As enacted, Title V of ERTA, entitled Tax Straddles, combined parts of both the Senate and House bills.⁶⁹

B. Title V of ERTA

Title V of ERTA deals comprehensively with the taxation of commodity transactions. The fundamental provisions: (1) impose limits on the recognition of losses in "straddle" positions;⁷⁰ (2) require "regulated futures contracts" (RFCs) to be "marked to market";⁷¹ and (3) require the capitalization of "interest and carrying charges" allocable to personal property held as part of a straddle.⁷² Also, T-bills are no longer specifically excluded from the definition of capital asset,⁷³ the time limit for dealer identification of investment transactions is shortened,⁷⁴ and contract cancellation transactions are treated as "sales or exchanges."⁷⁵ The effect of the legislation has been to preclude the use of commodity transactions for tax purposes.⁷⁶

⁶⁷ S. REP. NO. 144, 97th Cong., 1st Sess. 155-61 (1981) [hereinafter cited as S. REP.].

⁶⁸ *Id.* at 143-52. In addition, the bill proposed to require the capitalization of interest and carrying costs without the exception for futures traders contained in the House proposal. *Id.* at 153-54. The provisions of the Senate bill dealing with the treatment of T-bills, sales and exchanges of capital assets, and dealer identification of securities substantially were identical to the House bill. *Id.* 168-69, 170-71.

⁶⁹ See *infra* text accompanying notes 70-131.

⁷⁰ I.R.C. § 1092 (1982).

⁷¹ I.R.C. § 1256 (1982).

⁷² Amendment to I.R.C. § 263.

⁷³ Amendments to I.R.C. §§ 1221 and 1232.

⁷⁴ Amendment to I.R.C. § 1236.

⁷⁵ I.R.C. § 1234A (1982).

⁷⁶ On December 21, 1982, in the last days of the "Lame Duck" session of the 97th Congress, the Technical Corrections Act of 1982 (H.R. 6056) was passed by Congress and on January 12, 1983 was enacted into law, Pub. L. No. 97-448. See 1 WEEKLY TAX REP. (BNA) No. 26, 811, 811-12 (Dec. 27, 1982). As the title of the bill indicates, this legislation was drafted in order to make "technical, clerical, conforming, and clarifying amendments to provisions enacted by the Economic Recovery Tax Act of 1981 and certain other 1980 tax legislation." H.R. REP. NO. 794, 97th Cong., 2d Sess. 1 (1982). The following discussion incorporates the changes made to Title V by the Technical Corrections Act.

The Technical Corrections Act contains a number of "technical" amendments to Title V of ERTA as well as a few quasi-substantive changes in the new rules addressing some of the new commodity products that have been introduced into the markets since the enactment of Title V. Primarily, the amendments to Title V related to § 1256 which imposes the new mark to market regimen upon RFCs. In general, the provisions enacted by the Technical Corrections Act

ERTA gives the Treasury extensive regulatory authority to define and implement many of the provisions of Title V. Of necessity, the regulations promulgated will provide detailed answers to a number of general issues raised by the statute. As of this writing, however, temporary regulations have been issued only with regard to certain elective transition rules provided taxpayers by Title V.⁷⁷ No other regulations interpreting the provisions have been promulgated in temporary, proposed, or final forms. The following discussion is based on the language of the statute and the legislative history of the Act.

1. Limitations on the Recognition of Straddle Losses — Code § 1092

New Code section 1092, entitled "Straddles," precludes the recognition of loss with respect to certain property to the extent the taxpayer has an offsetting unrealized gain with respect to an interest in other property, and prevents the conversion of ordinary income and short-term capital gain into long-term capital gain through straddle transactions.

apply to property acquired and positions established after June 23, 1981 (the effective date of Title V). For legislative history of Technical Corrections Act, see TAX MGMT (BNA), Series III, primary sources, Current developments, 97th Cong., IV-6, 91, 93-175 (Nov. 30, 1982).

The other pieces of tax legislation enacted in 1980 that also were amended by the Technical Corrections Act are: the Crude Oil Windfall Profit Tax Act of 1980 Pub. L. No. 96-223, 94 Stat. 229; the Installment Sales Revision Act of 1980 Pub. L. No. 96-471, 94 Stat. 2247; the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389; and the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248. See GENERAL EXPLANATION, *supra* note 2, at 59, 159, 316-324.

⁷⁷ The provisions of Title V generally apply to "property acquired and positions established" after June 23, 1981. GENERAL EXPLANATION, *supra* note 2, at 291, 304, 307, 310, 312, 314. This date originates from the bill introduced in the Senate by Senator Daniel P. Moynihan on June 25, 1981. 127 CONG. REC. S7119. Two exceptions to this general rule exist. The identification requirements contained in the amendment to § 1236, relating to the identification of securities by securities dealers, became effective August 13, 1981, the date of the enactment of ERTA. Additionally, new § 1256(e)(2)(C), relating to the designation of hedging transactions on the day acquired, applies only to property acquired and positions established after December 31, 1981.

Taxpayers, however, may elect to have the provisions of Title V apply to all RFCs and positions held on or before June 23, 1981 under either of two elections. Under § 508(c) of Title V, a taxpayer could elect to have all of the new rules apply to all positions held on June 23, 1981. Pub. L. No. 97-34, § 508(c), 95 Stat. 172, 333. If this election were made, all positions held on June 23, 1981 would come under all of the provisions of Title V.

In lieu of a § 508(c) election, a taxpayer holding RFCs could make an election with respect to such contracts under § 509 of Title V for the taxable year which includes June 23, 1981. Pub. L. No. 97-34, § 509, 95 Stat. 172, 333-35. This election provided that a taxpayer could defer a portion of the income tax liability attributable to unrealized gains on RFCs if he elected to treat all RFCs held at any time during the taxable year beginning before June 23, 1981, and ending after June 23, 1981 under the mark to market rules of § 1256. If this election were made, gains and losses from the RFCs would be treated as if they had occurred after January 1, 1982, resulting in a maximum tax rate of 32 percent. This election served as a transition rule enacted to assist traders and other taxpayers who deal extensively in the futures markets in their adjustment to the new mark to market regimen for RFCs. Under this transition rule, a taxpayer could pay part or all of the tax liability with respect to unrealized RFC gains in up to five equal installments.

(i) *The Limitation on Loss Rule*

Section 1092(a) generally provides that losses incurred with respect to "positions" in "personal property" are deductible in the taxable year the losses are realized only to the extent they exceed "unrealized gains" in any "offsetting position."⁷⁸ "Personal property" means any personal property, other than stock, of a type which is "actively traded."⁷⁹ The term "actively traded" is not defined in Title V. The legislative history of Title V, however, provides some guidance for interpreting the term. The following statement of Senator Daniel P. Moynihan was made during the Senate discussion of Title V:

[T]he words "actively traded" are the key. Even though there is a market for leases in real estate, in our view, that market does not make real estate leases actively traded. Nor are mimeograph machines, desks and other contents of office buildings actively traded.⁸⁰

The Report of the Joint Committee on Taxation regarding ERTA also attempts to clarify the term by stating that "in order to be treated as actively traded, property need not be traded on an exchange or in a recognized market."⁸¹ Therefore, it is assumed that the term "personal property" will be broadly construed.

A "position" is any interest in personal property, including futures, forward and option contracts giving the holder rights in such property.⁸² Thus, actively traded futures contracts, forward contracts, and other interests in personal property may constitute positions with respect to other property as well as personal property in and of themselves.⁸³

An "offsetting position" is a position in personal property, the holding of which substantially reduces the risk of loss from holding another position in the same or related personal property.⁸⁴ A "straddle" means offsetting positions

⁷⁸ Prior to the application of § 1092(a), however, a new "wash sale rule" to be implemented by regulation may otherwise prevent the deductibility of straddle losses. Straddle loss deductibility, therefore, is limited both by the new wash sale rule and by gains embodied in personal property held in offsetting positions. See *infra* notes 102-06 and accompanying text.

⁷⁹ I.R.C. § 1092(d)(1). The legislative history of the provision states United States currency does not constitute "personal property" for purposes of § 1092 because "only property or interests in property that may result in gain or loss on their disposition are subject to the straddle limitations." GENERAL EXPLANATION, *supra* note 2, at 289. Assuming the Treasury will adopt the GENERAL EXPLANATION's interpretation of the definition of personal property in future regulations, personal property means any personal property, other than stock and property which will not result in gain or loss on its disposition, which is "actively traded."

⁸⁰ 127 CONG. REC. S8643 (daily ed. July 28, 1981).

⁸¹ GENERAL EXPLANATION, *supra* note 2, at 289.

⁸² I.R.C. § 1092(d)(2)(A). Under a special rule, stock options traded on domestic exchanges or on similar foreign exchanges designated by the Treasury with exercise periods of less than the minimum period required for long-term capital gain treatment (currently 12 months) are not considered "positions." I.R.C. § 1092(d)(2)(B).

⁸³ GENERAL EXPLANATION, *supra* note 2, at 289.

⁸⁴ I.R.C. § 1092(c)(2).

with respect to personal property.⁸⁵ A taxpayer thus holds "offsetting positions" in personal property if there is a substantial reduction in the taxpayer's risk of loss from holding any position in personal property because the taxpayer holds one or more other positions with respect to personal property.⁸⁶ Two positions in personal property may be treated as offsetting positions even if the two positions are not in the same underlying property or are not the same types of interests in property.⁸⁷ Although the concept of offsetting positions appears to be quite broad, the legislative history of Title V indicates that certain holdings covered by the literal definition of offsetting positions contained in section 1092 will not be considered to be offsetting positions.⁸⁸

Section 1092 contains an attribution rule which treats positions held by the taxpayer's spouse or a corporation which files a consolidated return with the taxpayer under section 1501 as if they were held by the taxpayer.⁸⁹ In addition, the same rule treats positions held by flow-through entities in which the taxpayer has an interest, such as trusts, partnerships, or subchapter S corporations, as if they were held by the taxpayer-beneficiary, -grantor, -member, or -shareholder if part or all of the gain or loss from the position held by the entity would properly be taken into account in determining the taxpayer's own Federal tax liability.⁹⁰

Two or more positions will be presumed offsetting if the value of one or more positions ordinarily varies inversely with the value of one or more other positions, and the positions: (1) are in the same personal property; (2) are in the same personal property but in a substantially altered form; or (3) are in debt instruments of similar maturity or debt instruments described in regulations to be promulgated.⁹¹ Positions also will be presumed offsetting if two or more positions have a lower aggregate margin requirement than the sum of the

⁸⁵ I.R.C. § 1092(c)(1).

⁸⁶ I.R.C. §§ 1092(c)(1), (2).

⁸⁷ For example, a taxpayer would hold offsetting positions if he held a long futures contract on silver and a short futures contract on silver coins.

⁸⁸ See GENERAL EXPLANATION, *supra* note 2, at 288 (risk reduction through mere diversification of investments usually will not be considered to substantially diminish risk for § 1092 purposes if the positions are not balanced). Thus, such holdings should not be considered offsetting positions and a taxpayer holding numerous securities in a portfolio should not be considered to be holding offsetting positions as long as no short positions in the same or similar securities are held. Query, however, whether a taxpayer holding both a securities portfolio and short stock index futures contracts will be considered to be holding offsetting positions.

For situations where one or more positions offset only a portion of one or more other positions, Title V authorizes the Treasury to issue regulations prescribing the method for determining the portion of a position which is to be considered offsetting. The legislative history notes that such positions should be treated as offsetting only to the extent of the portion of the position which is balanced. GENERAL EXPLANATION, *supra* note 2, at 288.

⁸⁹ I.R.C. § 1092(d)(3).

⁹⁰ *Id.* Thus, due to the ownership of an interest in a flow-through entity, a taxpayer may hold an interest through such entity which would be considered offsetting with respect to a position held in his personal portfolio of investments.

⁹¹ I.R.C. § 1092(c)(3).

margin requirements for each position held separately, or if such positions are sold or marketed as offsetting.⁹² The Treasury is authorized to issue regulations describing other factors which may establish a presumption that positions are offsetting.⁹³ This legislative authorization enables the Treasury to monitor the creative tax planner attempting to avoid the technical requirements of section 1092. Any presumptions established either explicitly by section 1092 or pursuant to the regulatory authority granted by section 1092, may be rebutted by either the taxpayer or the government.⁹⁴

Section 1092 limits the deductibility of losses incurred with respect to offsetting positions to the amount of losses which exceed the unrealized gain inherent in the offsetting positions. The amount of unrealized gain which must be taken into account for each straddle position held equals the amount of gain the taxpayer would realize if the position were sold or otherwise liquidated at its fair market value on the last business day of the taxable year.⁹⁵

Losses deferred under the provisions of section 1092(a) may be carried forward to the succeeding year.⁹⁶ Carryover losses, however, are subject to the application of the loss deferral rule and, therefore, may create offsetting positions in the succeeding year. Losses carried forward may be used to offset both commodity-related and non-commodity-related capital gains.⁹⁷

A taxpayer is required to disclose his unrealized gain from positions in personal property.⁹⁸ All positions with unrealized gain must be reported regardless of whether the positions are part of a straddle.⁹⁹ No disclosure is re-

⁹² *Id.*

⁹³ *Id.* Such factors may include subjective or objective tests.

⁹⁴ *Id.*

⁹⁵ As an example, assume a taxpayer holds two offsetting positions (A and B) in personal property in a taxable year and sells position A at a loss of 10x prior to the end of the year. At year-end, the taxpayer still holds position B. Position B, if sold on the last day of the taxable year, would generate a 4x gain for the taxpayer. Therefore, 4x of unrealized gain is inherent in position B, and the taxpayer may deduct only 6x of the loss (the amount of loss which exceeds the unrealized gain in position B) from the sale of position A. Section 1092(a) does not impose a tax upon unrealized gain from a straddle position. Rather, such gain limits the current recognition of losses which are realized from the disposition of other positions which are a part of a straddle.

In the case of exchange-traded futures contracts subject to the loss deferral rule, fair market value is determined by the final settlement prices set by the futures exchanges for each contract on the final trading day of the year. For other personal property, the applicable settlement price of the position normally will be considered the fair market value. GENERAL EXPLANATION, *supra* note 2, at 285-86.

⁹⁶ I.R.C. § 1092(a)(1)(B).

⁹⁷ *Id.*

⁹⁸ I.R.C. § 1092(a)(3)(B).

⁹⁹ See INTERNAL REVENUE SERVICE FORM 6781 (Gains and Losses from Commodity Futures Contracts and Straddle Positions).

ERTA added a subsection to § 6653 which imposes a penalty on a taxpayer, who without reasonable cause, fails to report unrealized gain as required, and has an underpayment of any tax attributable in whole or in part to the subsequent denial of a loss recognition with respect to any position. I.R.C. § 6653(g). Any such underpayment will be treated as if due to negligence or intentional disregard of rules and regulations of the Code, but without intent to defraud. Any

quired, however, if the only loss sustained by a taxpayer was a loss with respect to: (1) inventory or depreciable trade or business property; (2) hedging transactions; or (3) "identified straddles."¹⁰⁰

In addition, a taxpayer will not be required to report unrealized gain on positions held during the taxable year if no loss is sustained on any position during the taxable year. This exception does not apply, and the unrealized gain on all positions in personal property held at the end of the taxable year must be reported, if any losses whatsoever are realized on positions in personal property, even if the taxpayer realizes no net loss for the year. Further, if the taxpayer has sustained a loss from the disposition of a short position in a prior year which is deferred by section 1092, the taxpayer may have offsetting positions in the current year as a result of the loss carryover and may be required to report unrealized gain.

Although the numerous nuances of the loss deferral rule are complex, a simple example illustrates the controlling principle. Assume that in August a calendar year taxpayer enters into a forward contract calling for delivery of a specified quantity of gold in December at a specified price and then purchases the underlying "actively traded" personal property (gold) in September. For purposes of section 1092, the taxpayer holds offsetting positions. If the taxpayer closes out the forward contract in November and realizes a loss on the transaction (which is otherwise allowable under a new wash sale rule), the loss will be allowed only to the extent it exceeds any unrealized gain in the gold still held. If actual loss and unrealized gain are both 15x, no current deduction is available. If the loss on the forward contract is 15x and the unrealized gain on the offsetting position is 5x, the taxpayer will be able to deduct a loss of only 10x in the taxable year. The 5x loss remaining may be carried over to the succeeding taxable year. This rule effectively puts an end to the classic straddle transactions in which tax losses could be generated without a corresponding economic loss to the taxpayer.¹⁰¹

(ii) *Wash Sale Rule*

Section 1092(b) provides the Treasury with the authority to prescribe regulations which will impose rules for straddle transactions that are similar to the wash sale rules contained in sections 1091(a) and (d). As of this date, no such regulations have been promulgated. Nonetheless, according to the

penalty assessed will be in an amount equal to five percent of the underpayment of tax, and an additional penalty of 50 percent of the interest due under § 6601 will be imposed on that portion of the underpayment attributable to the taxpayer's failure to file the required reports.

¹⁰⁰ I.R.C. § 1092(a)(3)(B)(ii). An "identified straddle" is a straddle which is designated on the taxpayer's records as an identified straddle before the close of the day the straddle positions are acquired, is made up of positions acquired on the same day and either disposed of on the same day or held through the end of the taxable year, and is composed of positions which are not part of a larger straddle. See *infra* § 15.14 notes 115-19 and accompanying text.

¹⁰¹ See *supra* § 15.07 notes 35-52 and accompanying text.

legislative history of Title V, the new wash sale rule embodied in section 1092(b) supersedes any present law applications of section 1091 to straddle positions.¹⁰² The wash sale provision was enacted to attack the tax shelter straddle transaction wherein the taxpayer, after disposing of the loss leg, immediately replaces it in order to remain in a balanced position and protect the unrealized gain in the other leg.¹⁰³

Under the present wash sale rule of section 1091, a loss sustained with respect to the sale or other disposition of stocks and securities is not deductible currently if the taxpayer acquires, or enters a contract or option to acquire, a "substantially identical" asset within a period beginning thirty days before the date of the sale or other disposition of the stock or securities and ending 30 days after the date of the disposition.¹⁰⁴ The new regulations applicable to straddle transactions will substitute the concept of "offsetting positions" for the present law concept of "substantially identical" property.¹⁰⁵ The new regulations similar to the wash sale rule of section 1091, therefore, should defer a loss resulting from a straddle position that is replaced within thirty days with another offsetting position.¹⁰⁶ It is unclear, however, whether the deferred loss will be recognized at the time the successor straddle position is disposed of, or if the recognition of the loss will be deferred until all positions that make up the straddle are liquidated. In either case, it must be remembered that current recognition of a loss allowed under the new wash sale rule still may be denied by reason of the loss deferral rule.

(iii) *Short Sale Rule*

In addition to the wash sale rule, section 1092(b) also gives the Treasury the authority to issue regulations creating short sale rules which are to be "similar" to the existing short sale provisions of subsections (b) and (d) of section 1233 of the Code. As of this writing, no regulations pursuant to this authority have been promulgated.

Under the short sale rules of section 1233(b), gain realized from a short sale¹⁰⁷ of a capital asset will be short-term capital gain if on the date of the short

¹⁰² S. REP., *supra* note 67, at 149; GENERAL EXPLANATION, *supra* note 2, at 287. See *Trenton Cotton Oil Co. v. Commissioner*, 148 F.2d 208 (6th Cir. 1945); see also *supra* § 15.07, notes 35-52, and accompanying text.

¹⁰³ The legislative history of Title V provides the basis for this conclusion: "It is intended that the wash-sale rule be applied in appropriate cases to disallow losses in certain straddle transactions prior to the loss deferral rule of new section 1092." S. REP., *supra* note 67, at 149.

¹⁰⁴ I.R.C. § 1091(a). Section 1091(d) provides that the basis of the substantially identical asset acquired equals the basis of the asset sold either increased or decreased by the difference between the price the original asset was acquired and the price the substantially identical asset is eventually sold.

¹⁰⁵ S. REP., *supra* note 67, at 149.

¹⁰⁶ *Id.*

¹⁰⁷ A short sale is one in which the seller borrows the property from another which is sold to the buyer. Subsequently, the seller either purchases similar property and delivers such proper-

sale the taxpayer has held substantially identical property for less than one year or acquires such property after the short sale and on, or before, the date of closing of the short sale.¹⁰⁸ The holding period of any property substantially identical to the property sold short, which is not used to cover the short sale, begins only when the short sale is covered.¹⁰⁹ The time such substantially identical property was held before the short position was created is disregarded for holding period purposes unless the taxpayer had already held such property for a period exceeding the long-term holding period requirement for the property.

Section 1233(d) provides that any loss incurred with respect to a short sale is a long-term capital loss, regardless of the period the property used to close the short sale was held, if the property substantially identical to the property sold short has been held for more than one year.

The legislative history of Title V again provides the only guidance for the regulations to be promulgated. The Report of the Senate Committee on Finance states that the regulations which implement the new short sale rule should consider "a futures contract to sell a commodity . . . equivalent to the short sale of a long futures contract for the same commodity or the short sale of the commodity itself."¹¹⁰ Additionally, the Report directs the Treasury to issue regulations which "suspend the commencement of the holding period for any positions which are part of a straddle subject to new section 1092."¹¹¹

The General Explanation follows this interpretation, but states that the new short sale rules will terminate the holding period of a long position in a straddle unless the long-term holding period requirement was already satisfied with respect to that position.¹¹² The new short sale rules will supersede any current law applications of section 1233 to straddle positions.¹¹³

ty to the lender to close the short sale, or delivers property which he held but did not wish to transfer at the earlier date. *See* *Provost v. United States*, 269 U.S. 443 (1926). A short futures contract is not a short sale in the traditional sense because the holder of such a futures contract has not made present delivery of any property, borrowed or otherwise.

¹⁰⁸ I.R.C. § 1233(b).

¹⁰⁹ *Id.*

¹¹⁰ S. REP., *supra* note 67, at 149.

¹¹¹ This latter statement was subsequently clarified in the following colloquy between Senators Moynihan and Dole on the floor of the Senate:

Mr. Moynihan. I would like to ask the chairman of the Finance Committee to clarify the intent of the committee concerning one aspect of the loss deferral rules. Section 1092(b) of the bill provides that rules similar to those of section 1233(b) and (d) are to be promulgated by regulation. Am I correct in my understanding that the rules of [sic] paralleling section 1233(b) will be applied to provide that a position in commodities that is not marked to market will terminate the holding period of any other offsetting position that has not been held for more than 12 months.

Mr. Dole. The distinguished Senator from New York is indeed correct in his application of the provisions of section 1092(b). Of course, such principle is only to be implemented by the regulations which the Secretary is required to promulgate.

127 CONG. REC. § 8644 (daily ed. July 28, 1981).

¹¹² GENERAL EXPLANATION, *supra* note 2, at 287.

¹¹³ *Id.*

This new regulatory short sale rule for actively traded property will be the key to preventing an investor from generating long-term capital gain with respect to an investment asset where the investor holds another position that effectively protects him from risk of loss. The new short sale rules promulgated under section 1092(b) are likely to be the most significant regulations promulgated under Title V in that they represent the exclusive remedy for preventing "conversion" into long-term capital gain.

(iv) *Stock Options*

As noted above, section 1092(d)(2) provides that the term "position" does not include domestically-traded (listed) options to buy or sell stock that is actively traded, provided the exercise period of such options does not exceed the holding period required for long-term capital gain treatment. Thus, certain straddles composed of listed stock options are exempt from the loss deferral, short sale, and wash rules of section 1092 if one of the options in the straddle is of a type with respect to which the maximum period during which such option may be exercised is less than the capital gains holding period. At present, listed stock options generally expire within nine months, and the capital gains holding period is one year. Therefore, straddles consisting of listed stock options generally are exempt from the provisions of section 1092.¹¹⁴

(v) *Identified Straddles*

Title V contains two exceptions to the loss deferral rules of section 1092 — one for "identified straddles" and the other for "hedging transactions."¹¹⁵ A taxpayer may choose to designate certain straddle positions as "identified straddles."¹¹⁶ An identified straddle is a straddle which: (1) is designated on the taxpayer's records as an identified straddle before the close of the day the straddle positions are acquired; (2) is made up of positions acquired on the same day and either disposed of on the same day or held through the end of the taxable year; and (3) is composed of positions which are not part of a larger

¹¹⁴ During the 97th Congress, an amendment that would have reduced the holding period for determining whether a gain or loss on the sale or exchange of a capital asset is long-term or short-term from one year to six months was added to a bill dealing with the accounting methods of public utilities (H.R. 1524) in the Senate. Under this amendment, straddles composed of listed stock options which expire within nine months would no longer have been excluded from the provisions of § 1092. However, the amendment provided that listed stock option straddles would have remained exempt from the loss deferral, wash-sale, and short-sale rules if none of the positions in the straddle could produce long-term capital gain or loss. In the case of syndicates, the straddles would have been exempt only if none of the positions could produce either long-term capital gain or loss or ordinary income or loss. See 128 CONG. REC. § 14235 (daily ed. Dec. 9, 1982). The amendment was eventually deleted from H.R. 1524 in the last days of the 97th Congress. However, a bill (S. 13) to shorten the capital gains holding period from one year to six months with the same provisions for stock options and syndicates was introduced January 26, 1983 in the 98th Congress.

¹¹⁵ I.R.C. § 1092(a)(2).

¹¹⁶ I.R.C. § 1092(b)(2)(A).

straddle.¹¹⁷ If such a designation is made, the positions in the straddle are "isolated" from all other potential offsetting positions.¹¹⁸ Therefore, positions which are part of an identified straddle will not affect the holding periods of other offsetting positions under the short sale rule, or defer the recognition of losses under the new wash sale rules or cause the deferral of losses or the capitalization of interest and carrying charges (new section 263(g)) with respect to other positions which are not part of the identified straddle. Any loss sustained with respect to a position in an identified straddle, however, is treated as sustained not earlier than the day on which all the positions making up the identified straddle are disposed of.¹¹⁹

(vi) *Hedging Transactions*

The second exception from the section 1092 loss deferral rules applies to "hedging transactions." Hedging transactions also are explicitly exempted from the capitalization of interest and carrying charges rule of section 263(g) and the wash sale and short sale rules of section 1092.¹²⁰ For these purposes, "hedging transactions" are defined as those transactions entered into by the taxpayer in the normal course of the taxpayer's business primarily to reduce the risk of price change or currency fluctuations with respect to property the taxpayer holds, or will acquire and hold, which, if disposed of, would produce ordinary gain or loss.¹²¹ In addition, a hedging transaction may be a transaction used to reduce the risk of price or interest rate changes, or currency fluctuations with respect to borrowings made or to be made, or obligations made or to be made by the taxpayer, provided all income or gain on the borrowings or obligations is treated as ordinary income.¹²² The taxpayer must treat any gain or loss on dispositions of either the hedged property or the hedge as ordinary gain or loss.¹²³

To qualify a transaction for this exemption, a taxpayer must clearly identify the transaction in his records as part of a hedging transaction before the close of the day during which the taxpayer entered the transaction.¹²⁴ If the tax-

¹¹⁷ I.R.C. § 1092(b)(2)(B).

¹¹⁸ Section 1092(a)(1)(A)(iii) eliminates unrecognized gain with respect to a position in an identified straddle will not be treated as offsetting with respect to any position which is part of an identified straddle.

¹¹⁹ I.R.C. § 1092(a)(2)(A)(ii).

¹²⁰ I.R.C. §§ 263(g)(3) and 1092(e).

¹²¹ I.R.C. § 1256(e)(2)(A).

¹²² *Id.*

¹²³ GENERAL EXPLANATION, *supra* note 2, at 299.

¹²⁴ Both the Senate Finance Committee Report and the General Explanation note that in situations where a taxpayer engages in hedging transactions which are numerous and complex, and the opportunities for manipulation of the transactions to achieve deferral or conversion of ordinary income into capital gain are minimal, hedging transactions will be sufficiently identified if the taxpayer enters them in specifically designated "hedging accounts." S. REP., *supra* note 67, at 159; GENERAL EXPLANATION, *supra* note 2, at 330. However, if a taxpayer does not

payer once designates any personal property as being part of a hedging transaction, the taxpayer must treat any gain from the subsequent sale or other disposition of the property as ordinary gain.¹²⁵

The legislative history of Title V indicates that prior law characterizing the gain or loss on transactions constituting an integral part of the taxpayer's business as ordinary gain or loss will continue to apply.¹²⁶ The scope of the hedging transaction doctrine enunciated by the Supreme Court in *Corn Products Refining Co. v. United States* could go well beyond the scope of the exemption provided for hedging transactions.¹²⁷ Thus, a taxpayer may enter into transactions which are "hedged" resulting in ordinary income or loss, but which do not fall within the hedging exemption.¹²⁸

The hedging exemption does not apply to hedging transactions entered into by "syndicates."¹²⁹ A "syndicate" is any partnership or other flow-through entity which allocates more than thirty-five percent of its losses during the taxable year to limited partners or limited entrepreneurs (i.e., one who has an interest in the entity other than as a limited partner, but who does not actively participate in the management of the entity). The syndicate rule was enacted to prevent the possible manipulation of the hedging exemption by tax shelters structured as limited partnerships.¹³⁰

Title V lists four situations in which interests held by limited partners or by limited entrepreneurs will not be treated as passive interests for purposes of applying the thirty-five percent test.¹³¹ First, an interest will be considered ac-

maintain and manage his ordinary income transactions separately from his capital account and factors indicate manipulation is possible, it is anticipated that more detailed identification requirements will be required.

¹²⁵ I.R.C. § 1256(f). This rule, however, applies only to personal property of a type that is actively traded, excluding stock. Therefore, if a taxpayer holds a long stock position and an off-setting short forward contract and identifies the positions as a hedging transaction, the rule would not apply. Any gain on the stock or forward contract ultimately realized would not become ordinary if it would otherwise be capital, and any loss on the transaction would not be deferred by reason of § 1092 since the two positions would not constitute a straddle.

¹²⁶ GENERAL EXPLANATION, *supra* note 2, at 300. The concept of what constitutes a "hedge" for Federal income tax purposes has evolved over a period of 50 years in a myriad of factual settings. This article cannot undertake to fully explain the complex evolution of the rules.

¹²⁷ 350 U.S. 46 (1955).

¹²⁸ In addition, the treatment of transactions such as those hedging interest rate risks, which would be considered "hedged" for Title V purposes but for the fact that no gain or loss, neither ordinary nor capital, will be recognized with respect to the risk being hedged is unclear. The Senate Finance Committee Report, in its explanation of the hedging exemption, states that:

A hedging transaction may be executed to reduce risk of price or interest rate changes, or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer, provided all income or gain on such borrowings is treated as ordinary income.

S. REP., *supra* note 67, at 159. No mention is made in the legislative history of ERTA regarding whether hedging transactions which alone produce no gain or loss will come under the hedging exemption to § 1092 if the property financed by the borrowings produces ordinary income or loss.

¹²⁹ I.R.C. § 1256(e)(3).

¹³⁰ GENERAL EXPLANATION, *supra* note 2, at 300.

¹³¹ I.R.C. § 1256(e)(3)(C).

tive for any period that the holder of the interest actively participates in the management of the entity. Second, an interest held by the spouse, children, grandchildren, or parents of an individual who actively participates in the management of the entity will not be counted as a limited or passive interest. Third, an interest held by an individual who has actively participated for at least five years in the management of the entity is not considered a passive or limited interest. Fourth, an interest held by the estate of an individual who actively participated in the entity for at least five years, and an interest held by the estate of the spouse, children, grandchildren, or parents of such an individual, are not to be treated as limited interests. Additionally, the statute gives the Treasury the authority to determine, by regulation or otherwise, whether certain other interests in entities which are not used for tax avoidance purposes should be treated as active interests.

Banks, by special rule, are allowed to invoke the hedging exemption for transactions entered in the normal course of business. Banks need not have entered the transactions to reduce the risk of price of currency change or interest rate fluctuation.¹³²

2. "Regulated Futures Contracts" — Code §§ 1256 and 1212

The loss deferral rules of section 1092 apply to positions in all actively traded personal property. With respect to most futures contracts, Congress also provided a unique system of taxation in new section 1256 of Title V. This new regimen, known as the "mark to market" rules, was enacted to limit the use of tax shelter schemes involving futures contracts by taxing such transactions in a manner intended to reflect cash flows associated with the mark to market accounting systems employed by domestic commodity exchanges.¹³³ The application of the rules of section 1256 is limited to "regulated futures contracts" (RFCs), in contrast to the broad application of the loss deferral rules of section 1092.

(i) *Definition of Regulated Futures Contract*

The definition of an RFC has two principal elements.¹³⁴ First, the contract must be marked to market under a daily cash flow system used to determine

¹³² I.R.C. § 1256(e)(4).

¹³³ S. REP., *supra* note 67, at 155-57. In light of the comprehensive loss deferral rules of § 1092, it is uncertain whether the mark to market rules were necessary to limit tax avoidance schemes involving futures contracts.

¹³⁴ As originally defined in ERTA, an RFC had three principal elements. In addition to the mark to market and designated exchange requirements, an RFC had to be a contract that required the delivery of personal property, other than stock, which property was "actively traded," or a contract that required the delivery of an interest in such property. However, after the enactment of ERTA, the Commodity Futures Trading Commission authorized trading in several mark to market futures contracts that required the delivery of cash, not personal property (*i.e.*, stock index futures contracts). In order to clarify the tax treatment of such products, the

margin requirements as a result of daily price changes.¹³⁵ Second, the contract must be traded on or be subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission (CFTC) or any other board of trade which the Treasury determines operates under rules adequate to carry out the purposes of the mark to market rule.¹³⁶ All futures contracts traded on domestic exchanges are RFCs under this definition.¹³⁷

In addition, foreign currency forward contracts traded through the interbank markets that require the delivery of foreign currencies which are also traded through RFCs are treated as RFCs. Such bank forward contracts are not subject to a daily variation margin mark to market system.

(ii) *Mark to Market*

Under section 1256(a)(1), an RFC held through the end of a taxable year is treated as if sold for its fair market value on the last business day of the taxable year. Additionally, an RFC is "marked to market" when the taxpayer terminates or transfers his obligation with respect to the RFC during the taxable year by offsetting, by taking or making delivery, or otherwise.¹³⁸ Generally, the settlement price determined by an exchange for its futures contracts on the last business day of the year or on the day the taxpayer's obligation with respect to the RFC is terminated is considered to be the RFC's fair market value. The mark to market rule applies to a transfer notwithstanding that nonrecognition of gain or loss would result from the application of other Code provisions.¹³⁹

If a taxpayer holds an RFC at the beginning of a taxable year, any gain or loss subsequently realized on the RFC must be adjusted to reflect the gain or loss taken into account in the preceding year.¹⁴⁰ Unless an RFC specifically is exempted from the provisions of section 1256,¹⁴¹ the mark to market rule applies to all RFCs regardless of whether they are a part of a straddle.

Technical Corrections Act of 1982, Pub. L. No. 97-448, modified the definition of an RFC by deleting the delivery of personal property requirement. H.R. Rep. No. 97-986, 97th Cong., 2d Sess., 26 (1982).

This modification of the definition of an RFC at first appears to make the daily variation margin requirement the essential feature of an RFC. However, in spite of this general definition based upon marking to market, certain foreign currency contracts that are not subject to a daily variation margin system also were included in the definition of an RFC by the Technical Corrections Act of 1982.

¹³⁵ I.R.C. § 1256(b)(1).

¹³⁶ I.R.C. § 1256(b)(2).

¹³⁷ Query whether exchange-traded options (other than stock options) would be considered RFCs if both writers and holders were subject to variation margin requirements.

¹³⁸ I.R.C. § 1256(c).

¹³⁹ See GENERAL EXPLANATION, *supra* note 2, at 297.

¹⁴⁰ I.R.C. § 1256(a)(2) (1982).

¹⁴¹ See *supra* discussion of mixed straddles at text accompanying notes 152-55 and discussion of hedging transactions at text accompanying notes 120-31.

Section 1256 applies the doctrine of constructive receipt to gains in a futures trading account at year-end.¹⁴² Further, the doctrine is expanded to cover the recognition of losses in such accounts at year-end. To ameliorate the harshness of this unique rule applicable only to RFCs and to encourage trading in futures markets, Congress included the special forty/sixty tax rate in the mark to market rule.¹⁴³ Further, Congress enacted special provisions to deal with straddles composed of only RFC positions and straddles composed of RFCs and other positions in personal property.¹⁴⁴

(iii) *Special Tax Treatment for RFCs*

If an RFC is a capital asset in the taxpayer's hands,¹⁴⁵ the capital gain or loss on the RFC recognized due to the mark to market rule is treated as if forty percent of the gain or loss were short-term capital gain or loss, and as if sixty percent of the gain or loss were long-term capital gain or loss.¹⁴⁶ This is the case regardless of how long the taxpayer has held the RFC. Thus, the general capital gain holding period requirements are eliminated for RFC positions governed by section 1256. This section provides identical treatment for both long and short RFC positions. Moreover, the Technical Corrections Act¹⁴⁷ amended and limited the "tacked holding period" rule of section 1223(8), which provides that the period a taxpayer has held a commodity futures contract is included in the holding period of the commodity acquired pursuant to the contract, to futures contracts that are not governed by section 1256. Thus, a taxpayer that acquires property pursuant to an RFC subject to the mark to market rules no longer may include the period the RFC was held in the holding period of the underlying property.

A simple example illustrates how the new mark to market rules and forty/sixty tax treatment operate. Assume on June 3, 1983 a calendar year taxpayer enters into an RFC which requires him to purchase a specified quality and quantity of silver at \$10X in March, 1984. The taxpayer holds the RFC until February 1, 1984.

On December 30, 1983 (the last trading day of the year), the exchange settlement price for the same March, 1984 silver RFC is \$110X. Therefore, the

¹⁴² GENERAL EXPLANATION, *supra* note 2, at 296.

¹⁴³ See *infra* notes 146-49 and accompanying text.

¹⁴⁴ See *infra* notes 150-51 and accompanying text.

¹⁴⁵ The 40/60 treatment for gains and losses attributable to RFCs is not intended to affect the character of such contracts as capital assets. RFCs which would be treated as ordinary income assets under the rule of *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), will continue to yield ordinary income or loss. GENERAL EXPLANATION, *supra* note 2, at 297. Such RFCs, however, will be marked to market at year-end or upon disposition.

¹⁴⁶ Under the long-term and short-term capital gain rates effective January 1, 1982 (maximum 50 percent tax rate for short-term capital gain and 20 percent tax rate for long-term capital gain), the maximum tax rate applicable to income generated by RFCs marked to market after that date is 32 percent ($50\% \times .4 = 20\%$; $20\% \times .6 = 12\%$; $20\% + 12\% = 32\%$).

¹⁴⁷ See *supra* notes 70-77 and accompanying text.

taxpayer's rights under the contract have appreciated \$100X, and the taxpayer has received \$100X in variation margin. The mark to market rules require the taxpayer to take the \$100X, attributable to the appreciation in value of his RFC, into income for 1983. Under the special RFC rules, forty percent of the gain (\$40X) will be realized as short-term capital gain and sixty percent (\$60X) as long-term capital gain.¹⁴⁸

If the value of the RFC remains constant thereafter and the taxpayer closes out his position by offset on February 1, 1984, the taxpayer will not recognize any further gain or loss on the RFC. If the RFC either increases or decreases in value before the taxpayer closes out his position, however, any gain or loss subsequently realized on the RFC will be adjusted to reflect the gain taken into account with respect to the RFC in 1983. The taxpayer's basis in the RFC for purposes of calculating any subsequent gain or loss therefore is increased by \$100X. Thus, if the RFC subsequently declines in value and the taxpayer closes out his position by offset when the March price is \$70X on February 1, 1984, he will realize a loss of \$40X attributable to the RFC (\$110X - \$70X). Forty percent of the loss will be recognized as short-term capital loss (\$16X) and sixty percent as long-term capital loss (\$24X) in 1984.

Similarly, if the taxpayer takes delivery of the silver in March, 1984, gain or loss with respect to the RFC must be recognized. His basis in the property acquired is the original price specified in the RFC plus any gain and minus any loss previously recognized on the RFC (at year end and/or at delivery). In the example, the RFC would be marked to market both at the end of 1983 and at delivery. Thus, assuming the taxpayer's original contract price was \$10 and the contract was worth \$100 on December 30, 1983 and \$70 at the time of delivery, the taxpayer's basis in the silver acquired would be \$70 computed as follows: original contract price (\$10) + gain recognized at year end (\$100) - loss recognized at delivery (\$40) = basis of property acquired (\$70). Thus, the basis of property acquired pursuant to delivery under an RFC will always be the fair market value of the property at the delivery date. The period the RFC was held prior to delivery would not be included in the holding period of the silver.¹⁴⁹

(iv) *RFC-RFC Straddles*

If all positions in a straddle consist of RFCs, the provisions of section 1092 (i.e., the limitation on loss, wash sale, and short sale rules) do not apply.¹⁵⁰ Such straddle positions are governed only by the mark to market rules of sec-

¹⁴⁸ Assuming the taxpayer has no other gains or losses for the year, under the current maximum short-term capital gain (50 percent) rate and long-term capital gain (20 percent) rate, the taxpayer will pay \$32X in tax (\$40X × .5 = \$20X; \$60X × .2 = \$12X; \$20X + \$12X = \$32X).

¹⁴⁹ I.R.C. § 1223(8).

¹⁵⁰ I.R.C. § 1256(a)(4).

tion 1256. According to the legislative history, regulations will define the manner in which such RFC-RFC positions are to be matched.¹⁵¹

(v) *Mixed Straddles*

In other instances, a taxpayer may hold a "mixed straddle" consisting of both RFC and non-RFC positions. In the absence of a special rule, the RFC position would be subject to the mark to market rule while the non-RFC position would not be subject to such treatment. Therefore, any gain or loss on the RFC leg would have to be recognized at year-end while no such rule would apply to the unrealized gain or loss in the non-RFC leg. Further, a taxpayer would generate forty/sixty treatment with respect to gain or loss on the RFC leg¹⁵² and all short-term or long-term capital gain or loss on the other position.

To enable a taxpayer to avoid these results if he so desires, section 1256(d) provides a one-time election, revocable only with the consent of the Treasury, whereby the RFC positions in a mixed straddle will not be subject to the rule of section 1256.¹⁵³ The election, however, applies only to straddles wherein at least one, but not all, of the positions in each such straddle are RFCs. Moreover, an RFC will be excluded from the mark to market regimen only if, after making the election, the taxpayer identifies each position constituting a part of the mixed straddle not later than the close of the day the first RFC forming part of the straddle is acquired.¹⁵⁴ The effect of this dual process is that the taxpayer must make a mixed straddle election with respect to each mixed straddle.

If the taxpayer makes a mixed straddle election, the treatment of capital gains and losses from both the non-RFC and RFC positions as long-term or short-term capital gain will be determined by the period of time the taxpayer has held the position.¹⁵⁵ Furthermore, both the RFC and non-RFC positions will be subject to the loss deferral, wash sale, and short sale rules of section 1092.

¹⁵¹ S. REP., *supra* note 67, at 147-48. No such regulations have been published as of the date of this writing.

¹⁵² See *infra*, notes 153-56.

¹⁵³ The bill reported out of the Senate Finance Committee provided the taxpayer with two elections with regard to mixed straddles. As the Senate Report explained:

The taxpayer may elect to either treat all the positions in mixed straddles, regulated futures contracts as well as other property, on a mark-to-market basis for tax purposes; or to exclude all positions in the mixed straddle, including regulated futures contracts, from the mark-to-market rules, in which case, they will be subject to the loss deferral, wash sale, and short sale rules.

S. REP., *supra* note 67, at 158. The election to treat all positions in a mixed straddle under the mark to market rule was deleted on the Senate floor.

¹⁵⁴ I.R.C. § 1256(d)(4), as amended by the Technical Corrections Act of 1982.

¹⁵⁵ § 1223(8), as amended by the Technical Corrections Act of 1982, provides that the holding period of a commodity futures contract other than such a contract subject to § 1256 is six months.

A mixed straddle also may qualify as an "identified straddle" if the prerequisites of section 1092(a)(2)(B) are met.¹⁵⁶

(vi) *RFC Loss Carryback*

Loss carryback and carryover rules generally are perceived as necessary relief to ameliorate the often harsh results of the annual accounting requirement of the Code. By permitting taxpayers to use losses generated in one year to reduce income generated in another, the carryback and carryover rules provide a form of averaging income over a period of time beyond the single taxable year. Prior to ERTA, however, taxpayers other than corporations were not allowed to carry back capital losses. This limitation resulted in potentially serious tax problems for commodity floor brokers¹⁵⁷ since, except for transactions that constitute hedges,¹⁵⁸ all profits and losses attributable to commodity futures trading is considered capital gain or loss.¹⁵⁹ The inability to carry capital losses back thus resulted in a significant tax disadvantage to commodity professionals,¹⁶⁰ especially in light of the volatility of the markets.

Recognizing the harshness of the application of the loss carryback rules,¹⁶¹ Congress provided a three-year carryback rule for losses incurred with respect to RFCs. The rule, however, which applies only to losses incurred with respect to RFCs which are subject to the mark to market rules of section 1256¹⁶² and is quite complicated in its application.

If a taxpayer, other than a corporation, so elects, net commodity futures capital losses recognized under the mark to market rules of section 1256 may be carried back to each of the three preceding years and applied against net commodity futures capital gains recognized under that rule during such periods.¹⁶³ Net commodity futures capital losses for the taxable year equal the lesser of: (1)

¹⁵⁶ See *supra* GENERAL EXPLANATION, *supra* note 2, at 298 and discussion of identified straddles at notes 115-19 and accompanying text.

¹⁵⁷ Indeed, the inability to carry commodity losses back was cited by the commodity industry during consideration of Title V as a significant reason for allowing professional traders to use the "straddle" mechanism to accomplish a similar result. See Statement of Robert K. Wilmouth, President, Chicago Board of Trade, distributed at hearing of Senate Committee on Finance (June 12, 1981).

¹⁵⁸ A floor broker does not maintain an inventory to be hedged.

¹⁵⁹ For a discussion of why futures transactions are not considered dealer activity, see *supra* notes 31-34 and accompanying text.

¹⁶⁰ A dealer in securities would generate ordinary income or loss from dealer transactions and, therefore, losses from such activities could be carried back as a net operating loss under § 172.

¹⁶¹ GENERAL EXPLANATION, *supra* note 2, at 305.

¹⁶² Losses which may be carried back under new § 1212(c) may only be used to offset net gains incurred with respect to RFCs in the carryback year resulting from the application of the mark to market rule. Because the mark to market rule was enacted in 1981, no taxpayer has net mark to market gains for a prior year. Hence, 1981 is the earliest year to which net commodity futures losses may be carried back and the rule will not become fully operative until 1984.

¹⁶³ I.R.C. § 1212(c).

the difference between RFC capital gains and RFC capital losses; or (2) the sum of net short-term capital losses and net long-term capital losses for the taxable year. The election is available only if, after netting capital losses recognized with respect to RFCs under the mark to market rule of section 1256 with capital gains from other sources, a net capital loss for the year exists and that net capital loss would be a capital loss capable of being carried forward under section 1212(b).¹⁶⁴

If the taxpayer makes the election provided in section 1212(c), amounts carried back are treated as if forty percent of the losses were short-term capital losses and sixty percent were long-term capital losses. Such losses must be carried back to the earliest of the preceding three taxable years in which there is net commodity futures gain for the year. Any portion of the loss not allowed in the earliest year then may be carried to the other two taxable years in sequence. Carryback losses may not be used to increase or produce a net operating loss for the taxable year. Any net capital loss carried forward under section 1212(b), attributable to losses from RFCs, will retain its characterization as an RFC loss.¹⁶⁵

¹⁶⁴ I.R.C. § 1212(b) provides:

(b) Other Taxpayers —

(1) *In general.* — If a taxpayer other than a corporation has a net capital loss for any taxable year —

(A) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year, and

(B) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(2) *Special rules.* —

(A) For purposes of determining the excess referred to in paragraph (1)(A), an amount equal to the amount allowed for the taxable year under section 1211(b)(1)(A), (B), or (C) shall be treated as a short-term capital gain in such year.

(B) For purposes of determining the excess referred to in paragraph (1)(B) an amount equal to the sum of —

(i) the amount allowed for the taxable year under section 1211(b)(1)(A), (B), or (C), and

(ii) the excess of the amount described in clause (i) over the net short-term capital loss (determined without regard to this subsection) for such year, shall be treated as a short-term capital gain in such year.

¹⁶⁵ The new carryback rules of new § 1212(c) are complicated, but the following example taken from the GENERAL EXPLANATION will illustrate how they operate. Assume that a taxpayer in 1985 has net RFC capital losses of \$100,000, a \$3,000 short-term capital loss, \$50,000 in long-term capital gain, and \$3,000 of other income. The net RFC losses are treated as 60 percent long-term capital loss and 40 percent short-term capital loss. § 1211 allows the taxpayer to apply his capital losses against his long-term capital gain and short-term capital gain, leaving a \$50,000 loss. If the new carryback election is not made, the \$50,000 loss may be carried to 1986 under § 1212(b). Since the taxpayer has \$50,000 of long-term capital gain from non-RFC sources, only \$10,000 of long-term capital loss remains, which with the remaining \$40,000 of short-term capital loss is carried to 1986, and treated as losses from RFCs. If the taxpayer makes the carryback election, net losses from RFCs are carried back to 1982, but only to the extent of the net capital loss which could have been carried to 1986 under § 1212(b), i.e., \$50,000. The amount carried back is treated as 40 percent short-term capital loss and 60 percent long-term capital loss

(vii) *Hedging Transactions*

Section 1256 contains an exception for hedging transactions identical to the exemption from the loss deferral rules contained in section 1092 for the same type of transaction.¹⁶⁶ RFCs serving as positions in "hedging transactions" are not subject to the mark to market rules.¹⁶⁷ No formal election for this treatment is necessary. To obtain the exemption, a taxpayer must identify these transactions as hedges on the day he acquires the positions, and he must enter into the transactions in the normal course of business for the primary purpose of reducing the risk of price change or currency fluctuations regarding property held or to be held by the taxpayer, or to reduce the risk of interest rate or price changes, or currency fluctuations on borrowings or obligations made or to be made by the taxpayer, provided all income or gain on such borrowings or obligations is treated as ordinary income.¹⁶⁸ As with the hedging exemption of section 1092, gain with respect to property at any time designated as part of a hedge may not in the future be treated as gain with respect to a capital asset.¹⁶⁹ Similarly, "syndicates" are precluded from relying upon the hedging exemption.¹⁷⁰

3. Capitalization of Certain Interest and Carrying Charges — Code section 263(g)

To eliminate "cash and carry" tax shelters,¹⁷¹ Congress added a new subsection to section 263 of the Code which denies a deduction for "interest and carrying charges" allocable to personal property which is part of a straddle to the extent that such charges exceed the interest income generated by the personal property. The term "interest and carrying charges" includes the amount of interest charged to carry or purchase the personal property, the amounts incurred to store, insure, or transport the personal property, and the charges for the temporary use of personal property borrowed in connection with a short sale.¹⁷² These nondeductible expenses must be charged to the capital account of

in 1982, meaning the \$50,000 will yield \$20,000 short-term capital loss and \$30,000 of long-term capital loss from RFCs in 1982. These amounts may be applied only against RFC gains in 1982, and only to the extent the taxpayer had a net capital gain in 1982. If the taxpayer had a net RFC gain of \$50,000 and a \$30,000 long-term capital loss from non-RFC sources in 1982, the \$30,000 RFC long-term capital gain would be absorbed by the \$30,000 long-term capital loss, leaving a net short-term capital gain of \$20,000. This amount would be offset by the \$20,000 short-term capital loss carried back under the election leaving \$30,000 of unused losses which could be carried forward in the same manner to 1983 or 1984 to offset RFC gains. GENERAL EXPLANATION, *supra* note 2, at 306-07.

¹⁶⁶ See *supra* notes 78-131 and accompanying text.

¹⁶⁷ I.R.C. § 1256(e)(1).

¹⁶⁸ I.R.C. § 1256(e)(2). Banks need only enter the transactions in the normal course of business. I.R.C. § 1256(e)(4).

¹⁶⁹ I.R.C. § 1256(f)(1).

¹⁷⁰ I.R.C. § 1256(e)(3).

¹⁷¹ See *supra* discussion at § II(c).

¹⁷² I.R.C. § 263(g)(2)(A), as amended by the Technical Corrections Act of 1982.

the property for which the expenditures are incurred. The amount of expenditures to be capitalized is reduced by the sum of the amount of interest income (including original issue discount)¹⁷³ taken as gross income derived from the personal property, and any amount of acquisition discount, derived from the sale or exchange of any short-term government obligation, treated as ordinary income under the new Code section 1232(a)(4)(A).¹⁷⁴ Hence, interest, carrying charges, and interest equivalents paid with respect to short sales are deductible currently only to the extent that a position in straddled personal property generates interest income. Interest and carrying costs relating to hedging transactions that are exempt from the mark to market rules of section 1256 and the loss deferral, wash sale and short sale rules of section 1092 are not affected.¹⁷⁵

4. Government Obligations — Code §§ 1221 and 1232(a)

To eliminate the conversion of ordinary income into long-term capital gain through the use of T-bill straddles,¹⁷⁶ short-term government obligations issued on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue are now included within the definition of a capital asset contained in section 1221.¹⁷⁷ In addition, an amendment to section 1232(a) treats part of the gain realized on the sale or exchange of any such government obligation as ordinary income in an amount equal to the "ratable share of the acquisition discount" received by the taxpayer.¹⁷⁸ "Acquisition discount" is the excess of the stated redemption price of the government obligation at maturity (including any interest payable at maturity) over the taxpayer's basis for the obligation.¹⁷⁹ The "ratable share" is the portion of such discount equal to the ratio of the number of days the obligation is held to the number of days between the date of acquisition and the date of maturity.¹⁸⁰ Any gain exceeding the ratable share of acquisition discount is considered short-term capital gain. This provision does not apply to obligations with respect to which interest is not includable in income under section 103.¹⁸¹

¹⁷³ See I.R.C. § 1232.

¹⁷⁴ See *infra* discussion at text accompanying notes 176-81.

¹⁷⁵ I.R.C. § 263(g)(3).

¹⁷⁶ See *supra* notes 53-57 and accompanying text.

¹⁷⁷ Paragraph (5) of § 1221 which treated such short-term government obligations as ordinary income property was repealed by Title V.

¹⁷⁸ I.R.C. § 1234(a)(4)(A).

¹⁷⁹ I.R.C. § 1234(a)(4)(C).

¹⁸⁰ I.R.C. § 1234(a)(4)(D).

¹⁸¹ The application of these new rules may be illustrated by the following example. Consider a taxpayer who purchases \$1 million of 90-day T-bills for \$986,975, holds the bills for 30 days, and then sells the T-bills for \$992,175, realizing a \$5,200 gain. The acquisition discount is equal to \$13,025 (\$1,000,000 - \$986,975). Therefore, \$4,341.67 of the \$5,200 gain realized on the sale of the T-bills is treated as ordinary income ($30/90 \times \$13,025 = \$4,341.67$) and the remaining \$858.33 is considered short-term capital gain.

The statute refers only to the treatment of gains realized on the disposition of a short-term government obligation. The legislative history of this section, however, states that any loss

This change in the treatment of gains and losses from short-term government obligations only affects obligations that are held as capital assets. Hence, such obligations constituting inventory to the taxpayer will continue to receive ordinary gain and loss treatment.

5. Sale or Exchange of Capital Assets — Code § 1234A

To settle the confusion that had arisen regarding the treatment of contract rights, and to insure that gains and losses from transactions economically equivalent to the sale or exchange of a capital asset receive similar treatment,¹⁸² Title V added new section 1234A to the Code. This provision states that gains or losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to "personal property" which is or would be a capital asset, if acquired, or a regulated futures contract (as defined in section 1256) which is a capital asset in the hands of a taxpayer shall be treated as gains or losses from the sale of a capital asset.¹⁸³ All personal property (other than stock) of a type which is actively traded, as defined in section 1092(d)(1), and which is, or would be, an acquisition of a capital asset in the hands of the taxpayer is subject to this rule.¹⁸⁴

IV. REMAINING UNRESOLVED ISSUES

As the foregoing indicates, the new tax regimen imposed by Title V resulted from a comprehensive effort to provide an entirely new scheme for the

realized on the disposition of such an obligation will be considered short-term capital loss. S. REP., *supra* note 67, at 167. It is unclear whether loss on a short sale of a T-bill attributable to an "acquisition discount" equivalent would be treated as ordinary or capital.

¹⁸² See *supra* text at § II(D).

¹⁸³ I.R.C. § 1234A.

¹⁸⁴ Title V also redefined the investment account identification requirements for dealers in securities. Prior to the enactment of Title V, dealers in securities were required to identify and segregate securities held as investments within thirty days of the date of acquisition under § 1236 in order to be eligible to obtain capital gain or loss treatment on the disposition of such securities. The term "security" means any share of corporate stock, any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to any of the above.

Under the new law, securities acquired for investment by dealers must be identified as such before the close of the acquisition day. I.R.C. § 1236(a). Under this provision, no security which is part of an offsetting position may be treated as clearly identified in the dealer's records as a security held for investment unless all securities in the straddle are properly identified as held for investment. GENERAL EXPLANATION, *supra* note 2, at 312. Moreover, a security acquired pursuant to an option may be identified as held for investment only if the option also was properly identified as an investment asset.

Under a special rule, acquisitions made by "floor specialists" of stock in which the specialists are registered in connection with their duties on an exchange may be identified as being held for investment within a seven-day period after the date of acquisition. I.R.C. § 1236(d)(1). A "floor specialist" must be a member of a national securities exchange, be registered as a specialist with the exchange, and meet the requirements for specialists established by the Securities and Exchange Commission. I.R.C. § 1236(d)(2).

taxation of commodity transactions. While the statute does an excellent job of preventing the tax results that Congress intended to thwart, the legislation raises a number of significant new issues that must be addressed in the regulations to be promulgated. As noted, the magnitude of the regulatory authority granted to Treasury in this area is one of the more striking aspects of the legislation. In addition, the new products introduced in the commodity markets after the enactment of Title V pose other administrative and tax policy issues which remain unresolved.

With respect to the regulations to be issued, of paramount importance will be those implementing the new short sale rules of section 1092. It is unclear whether the operation of these short sale rules will result in the elimination or suspension of a taxpayer's holding period in property considered to constitute offsetting positions. Moreover, the new forty/sixty tax rate applicable to RFCs presents uncertainty with respect to the manner in which the regulations similar to section 1233(d) will apply to mixed straddles. As noted, under section 1233(d) a loss recognized on a short sale is recognized as long-term capital loss if substantially identical property was held prior to the time of the short sale for a period of time sufficient to qualify for long-term treatment. Since a taxpayer will be eligible for long-term treatment with respect to sixty percent of the loss sustained with respect to an RFC held as an offsetting position regardless of holding period, if the taxpayer does not make a mixed straddle election, it is unclear whether the new rules will require that all or only sixty percent of such loss on the non-RFC will be considered long-term. Finally, it is unclear whether the new short sale rules and wash sale rule under section 1092 will be made retroactively applicable to transactions or positions established prior to the date of enactment of the final regulations.

The regulations also must clarify the terms utilized in section 1092. For instance, the question of what is a "substantial" diminution of risk raises significant questions, especially where option positions are involved. Ordering rules for matching offsetting positions must be provided, especially for those taxpayers who utilize trading patterns that are not conducive to isolating legs of a straddle as simply as contemplated by the statute.

Even with these current ambiguities, section 1092 effectively puts an end to the conversion and deferral opportunities that were previously available in the commodity markets. In light of this result, it is unclear why it was necessary to enact the unique mark to market regimen and forty/sixty rate. Regardless of the reason, the advantages of the maximum thirty-two percent tax rate have prompted efforts to obtain the favorable rate for other types of commodity transactions, even at the "cost" of the imposition of the mark to market regimen.

Prior to the inclusion of bank forward currency contracts under the mark to market tax regimen, it appeared that forty/sixty treatment would only be available to commodity products subject to daily variation margin requirements. Now, however, it is unclear what, if any, factor is determinative of

whether such treatment is appropriate. From a tax policy standpoint, comparable tax treatment for all commodity products may be appropriate. Thus, future legislation may well expand, as the Technical Corrections Act of 1982 did, the current mark to market regimen of section 1256.